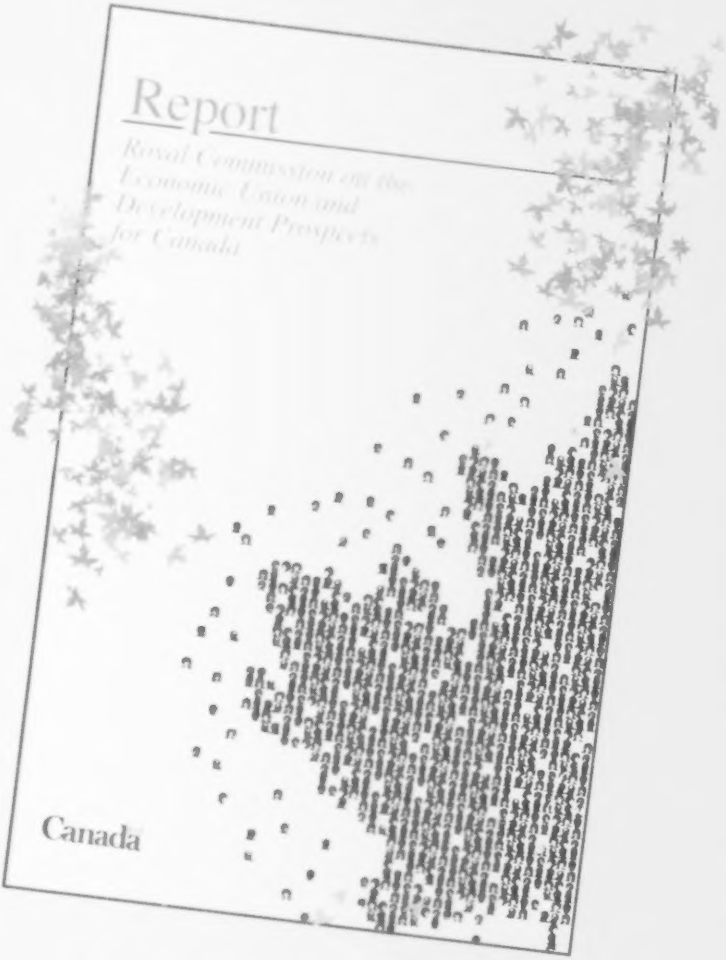
PROSPECTS FOR CANADA

Progress and Challenges 20 Years after the Macdonald Commission



Report

Royal Commission on the Economic Union and Development Prospects for Canada

Canada

David E.W. Laidler and
William B.P. Robson,
Editors

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Foreword

Twenty years ago, the report of the Royal Commission on the Economic Union and Development Prospects for Canada, chaired by the Hon. Donald Macdonald, set out recommendations that became a focus for the development of economic and social policy in Canada. One of its most important proposals was for a free trade agreement between Canada and the United States, an idea that the C.D. Howe Institute also considered in its research at that time.

This volume of papers reviews the contribution that the Macdonald Commission's Report made to Canadian public policy, examines the changes since then, and looks at the enduring lessons that policymakers can draw from its conclusions as they confront the complex challenges of today and tomorrow. David Laidler and William Robson, who organized the conference at which the papers published in this volume were initially presented, introduce the package and provide an excellent review of the primary issues.

I want to thank David and Bill for bringing together those papers in a book, as well as Kevin Doyle, who edited it. I also want to thank Wendy Longsworth and Diane King, who prepared it for publication. And certainly not least, I want to thank Donald Macdonald who contributed his thoughts 20 years after his Commission made its seminal contribution to Canadian public policy.

Jack M. Mintz
President and
Chief Executive Officer

Preface

William B.P. Robson

A volume to mark the 20th Anniversary of the publication of the *Report of the Royal Commission on the Economic Union and Development Prospects for Canada* may appear to need little justification. The Macdonald Commission is a pre-eminent landmark in Canadian economic policy. The Commission stands out for the astonishing amount of high quality research it commissioned and published. Its Report stands out for the reasoned tone of its discussion and recommendations. Even if the Report's recommendations had borne no fruit, the Commission's work would still be worth re-reading, discussing, and commemorating.

But, of course, the Macdonald Commission's recommendations did bear fruit. If Canada's economic union and development prospects are different, and in many respects better, than they were when the Commission began its work, some credit must go to the Commission's Report, and to the vigour with which Chairman Don Macdonald traveled the country to tell Canadians about it afterward. So the Report's 20th Anniversary is an apt point from which to look not just backward, but forward as well, and ask what lessons the Commission's work and subsequent experience offer as we confront Canada's economic challenges today.

Some of the Commission's work and recommendations affected policy directly, most notably Canada-U.S. free trade. Others affected policy more indirectly, such as fiscal stabilization. Yet others failed to make a mark, such as the guaranteed annual income. Still, all of them, in their substance, and in their consequences — or lack of them — contain lessons for Canadians today. That fact inspired David Laidler and me to commemorate the Report's release with a particular type of colloquium. We divided the Commission's work into four main areas: macro stability and economic growth; labour markets and social policy; international trade and federalism, and Canada's economic union. For each of those areas, we invited three experts to comment on, respectively, what the Commission's Report said, what has happened in the 20 years since, and what lessons the Report's recommendations and subsequent experience offer policymakers today.

David Laidler presents the substance of the contributions in the Rapporteur's Summary most ably at the end of this volume and I will not summarize them here. What does merit emphasis at the outset, however, is the overwhelmingly enthusiastic response to our invitations to present papers and to attend the conference. The contributors to this volume are superbly qualified, and the incisive discussion from the floor added in no small measure to the quality of the published papers. I thank the authors, the participants, and my co-editor David Laidler for their willing and able contributions to this project.

Special thanks are due to Don Macdonald himself. It may not be utterly shocking that Don responded positively when we first proposed this conference and volume to him. But his contribution went well beyond approval of the project: He made numerous valuable suggestions about framing the topics, and also contributed an address of his own, the essay that leads off the volume.

Not surprisingly, discussion about lessons for the future in each of the major policy areas often touched on the suitability of a modern-day royal commission to sort out today's challenges. Canada's royal commissions have a mixed record. Some stand out for the quality of their analysis and also for the impact of their recommendations; others fare poorly by either measure. Worse, some that stand out for their quality left little mark on policy, while others that were analytically weak left, or appear likely to leave, a larger policy legacy. Twenty years after the completion of its work, the Macdonald Commission stands out for the quality of its research, the ambition of its recommendations, and the advances in policy it fostered in several vital areas. Canadians seeking the right balance of established expertise and fresh thinking about today's economic and social challenges should find this volume's perspective on an outstanding Royal Commission informative and inspiring.

The Commission's Work and Report:
A Personal Perspective

Donald S. Macdonald

On occasion, a historical event may be captured in a single photograph. One such picture is the photo of Lord Strathcona, sledgehammer in hand and top hat on head, driving in the last spike of the Canadian Pacific Railway in British Columbia. Similarly, photographers captured the final signing of the *Constitution Act*, 1982, on Parliament Hill on a rainy April day.

The Queen is signing the constitutional document under the benevolent eye of Pierre Trudeau and in the background, two young men in morning suits are assisting in the process; they are Michael Pitfield, Clerk of the Privy Council, and Michael Kirby, Deputy Clerk.

They were the most senior public officials supporting the federal government in the constitutional negotiations. The creation of the Royal Commission on the Economic Union and Development Prospects for Canada was one of their next major endeavours.

An issue that influential Canadians and their political leaders had debated widely over the preceding half dozen years leading to the patriation of the British North America Act was how the constitution might be changed to provide for trade within the economic union. Discussion of that question had become stalemated in federal and provincial negotiations and it was put aside while the other changes were discussed and then carried through to adoption.

That question of seeking a better regime to govern internal trade remained on the personal agenda of the Prime Minister, and because of that, Michael Kirby turned up at my house in Toronto in the early autumn of 1982 to ask me to chair a commission to address the unfinished subject of the economic union.

Let me acknowledge at once that providing a specific and immutable framework for internal trade did not emerge from the Commission's deliberations, while a range of other public policy recommendations, which had not arisen in my recruitment, did.

In the end, the Royal Commission recommended a process rather than a legal amendment to deal with internal barriers to trade.[1] It would be for the First Ministers Conference to establish an entity to set up the institutions, and it would be the political process, not the courts, that would enforce it.

If economic union was the principal motive for the Royal Commission, why then are there three pages of so many other issues in the terms of reference?

Over the weeks that the Royal Commission mandate was being sculpted, I had observed this broadening of the mandate to a much wider set of issues, eventually numbering those three pages of text. What happened? I learned much later that, apart from the economic union, the government's advisers felt that this was an opportunity to have a wider public canvass of a range of policy concerns for which the policymakers had no clear solutions. In effect, it was acknowledged that the government had exhausted its mandate and new policy directions required exploration.

The governing party's program objectives had, for the moment, been attained and there was a lack of direction as to where policymakers should turn their attention next. As a result, the government decided to constitute a commission with broad terms of reference, to be conducted by a group representative not only of the geographical interests of the country, but also different functional interests, including political parties. Its objective was to be an examination of where Canadians were going as a nation, as well the great events that were going to shape the world around them. Ottawa wanted to study a broader group of issues than could effectively be dealt with within the formal structure of the public service, a wider scope of ideas and questions — and, if the recommendations were not acceptable to the government, it could disavow them.

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[1] The monograph of Kenneth Norrie, Richard Simeon and Mark Krasnick, *Federalism and Economic Union in Canada*, Volume 59 of the Commission's research, put the case on internal trade comprehensively.

The use of the Royal Commission instrument to develop broad policy responses has now become a pattern in Canada. Rowell-Sirois, Walter Gordon and our Royal Commission, each in its generation provided a perspective on the political economy of Canada, of our place within a changing world, and of policy responses for Canadians to choose.

The first task of the commissioners was to appoint senior staff. Gerry Godsoe became Executive Director; Alan Nymark, Director of Policy; and the Directors of Research were Ivan Bernier, Alan Cairns and David Smith. Several months into the Commission's work, David Smith received an invitation to become Principal of Queens University and stepped down as a Director of Research. Ken Norrie and John Sargent continued their existing occupations and heroically, in the roles of co-Directors of Research, undertook David's task, as well. The research began right away and resulted eventually in over 70 volumes of text dealing with the three major disciplines: economics, politics, and law — and with other subjects, as well.

A major contribution to the Commission's work was the program of public hearings which it held across Canada in the fall of 1983. While the appointment of the Royal Commission had been greeted with scoffing from large swaths of the media, Canadians throughout the country responded with enthusiasm to the opportunity to come and meet and discuss the nation's problems. The membership of the Commission was divided into teams and between us, over a three-month period, we went into all provinces and territories and talked with elected officials, other public leaders, and representatives of different groups — and just plain folks.

On the academic side, there was some skepticism about the value of the public hearing process. However, the commissioners were in no doubt that in the interests of political credibility, to enable the public to be heard, and also for the education of the commissioners, we should hear the opinions, often differing, of people from all across Canada.

Two of these hearings I still remember well. In Prince George, B.C., Ms. Dino, librarian at the public library, made a plea for government to make it possible for the emerging new means of communications to reach all of the communities throughout Canada, in the same way that the Carnegie endowment in the U.S. had brought learning to previous generations through the public library system. This was in the 1980s, when the Internet was still a mystery. She was a full decade ahead of her time, and was speaking of a technology which the Chairman, at least, did not know anything about; in retrospect it was a remarkably prescient recommendation.

On the other side of the country, in Saint-Georges-de-Beauce, Quebec, we had expected a refreshing presentation from the business community, which is known throughout the province for its enterprise. We were not disappointed. In a classic Quebec small town we heard presentations from local businessmen who were selling products around the world.

At the end of it all, with the hearings' testimony complete and the submissions received, the volumes of research and the conclusions distilled from it, the commissioners then had to sit many long hours agreeing on the text that embodied their conclusions.

Two particular events stand out in my mind because each affected the thinking of the Commission on issues which had not been in the work plan, though they were certainly present in the Commission's conclusions.

On the very first day, the Mining Association of British Columbia offered us an analysis of the competitive position of the base metal mining industries of Canada, indicating that the properties then being developed in British Columbia contained a much lower grade of ore than those that could potentially be exploited by competitors in South America and elsewhere in the developing world. One conclusion drawn by the commissioners from that discussion was that, while resource endowment would continue to be an important base for prosperity, it could not provide the rate of growth that Canadians had come to expect.

The other was at an informal meeting at the Park Public School in Regent Park South in downtown Toronto, from which it became clear that some of the public policies in place, federal, provincial and municipal, to assist the working poor were often competitive and even provided disincentives to those trying to work their way out of their disadvantage. That event was an important stimulus to the work undertaken by Rick Van Loon.

One of the ironies of the Commission's Report is captured in a phrase of Bill Robson, who said that it moved "decisively away from further dirigisme and towards economic liberalism".

The irony is that, looking back to the previous decade, the 1970s, in the two economic portfolios I had held as a minister, I had been responsible for highly dirigiste policies. In Energy, I had been the minister responsible for the National Oil Policy of 1973/1974, the incorporation of PetroCanada, the substantial investment by the federal government in Syncrude to maintain momentum in the oilsands, and Canadian participation in a price control regime for uranium exports.

In Finance, I had become the ultimate, comprehensive dirigiste over the whole economy, as the minister responsible for the wages and prices program.

What changed my viewpoint? My experience in the private sector after my departure from government made it clear that state-controlled programs had failed to achieve the rates of growth to which we all aspire. Did the Report bring about change? I would call as my witness the decade of the 1990s, in which a more open trading environment, and more conventional financial and monetary policies, achieved for Canada a much better economic performance.

Let me express some words of appreciation. I am indebted to Bill Robson and the C.D. Howe Institute, and David Laidler, for providing us this occasion to meet and to reflect on our labours of 20 years ago. Not least, it is a pleasure to gather again with so many of our co-workers from the mid-1980s. We all may have some afterthoughts as to what we recommended, but we can take satisfaction from knowing that our work has been used extensively by students and makers of public policy in the intervening years.

On a sadder note, as a popular hymn reminds us: "Time, like an ever-rolling stream, bears all its sons away." Alas, there are a number of our colleagues who are no longer with us, but whom we remember with respect. I mention one in particular who made a significant contribution to the Commission's work from the very earliest days until the final paragraph was written and to whom I was and am particularly indebted; he is Gerry Godsoe, who has since died. In his capacity as Executive Director, he took a lead role in creating an organization capable of responding to the heavy demands of an all-consuming order of reference and then, week after week, met the challenges, large and small, arising from the work program. With a high intelligence, he brought a unique capacity for mediation, and an instinct for policy direction that was invaluable.

In concluding, I offer a postscript to the Commission's work and on its recommendations, and I focus in particular on the recommendation that Canada seek a free trade agreement with the United States. While the Mulroney Government reserved its opinions on most of the recommendations, it responded almost immediately with an endorsement of the trade proposal.

Politically, that could not have been an easy choice within Cabinet, because the Conservatives had, for most of the century, been staunch opponents of opening our borders with the U.S. It would not have been a snap decision. The Commission had provided drafts of the near-final text of the Report to the Privy Council Office earlier in the year, pending a final draft in both official languages. Clearly, a decision had been taken by Mr. Mulroney and his colleagues during the months before the final Report became public. In retrospect, I admire their decisiveness and the way they were able to keep their discussion to themselves until the final Report did become public.

After publication of the Report there were declarations of support for the proposals and then, for a period of some months, no further overt acts to carry it forward. The supporters of the concept in the private sector were concerned at the absence of advocacy to counter the opposition to free trade building up on the public stage.

David Culver of Alcan, and Tom d'Aquino, as I recall it, took the initiative to form a private sector group in support of the concept. As co-Chairmen, Peter Lougheed and I were asked to lead a campaign of positive advocacy in Canada and with appropriate interest groups in the U.S.

It was agreed between us that we would divide the task between the regions, and between groups we each knew best. That turned out to be the short straw for me. While Peter addressed audiences in his own province, and elsewhere in Western Canada that had historically been in favour of free trade, I drew, among others, audiences in the industrial communities of southern Ontario, where there was strong union opposition: Oshawa-Bowmanville, St. Catharines, Burlington, in addition to Metro Toronto.

The debates were often spirited. None was more difficult for me than the Annual Meeting of the Liberal Party in Halifax, ironically the province of W.S. Fielding, the Finance Minister who had prepared the trade agreement in 1911.

A welcome ally to my side of the debate came from academe: Professor John Crispo. I will always be grateful for his robust platform technique which ultimately frightened away the union leaders from contested meetings where initially it was they who had brandished the verbal brass knuckles.

In the end however, it was the electors in the 1988 election who made the choice, and their judgment has been ratified by the results in the 1990s and in this century.

Macro Stability and Economic Growth:
What the Macdonald Commission Said

John Chant

In reading the 1985 Macdonald Report, I was surprised by some of the issues it proposed to cover: capital controls, tax-based incomes policies, inflation adjustment and the federal-provincial division of responsibility for fiscal and monetary policy. These have largely been absent from Canadian policy discourse during the careers of most of my economist colleagues. The report and other readings brought home to me just how different were the early 1980s.

The Environment

Cold facts, such as economic conditions, and even the state of macro-economic analysis, may still remain relatively fresh in our minds. Not so fresh is the intensity of the debate in the early 1980s about the state of the economy and economic policy.

The Canadian and the world economies were in worse shape in the years leading up to the appointment of the Macdonald Commission than at any time since the Depression of the 1930s. Both inflation and unemployment had increased substantially from their levels in the late 1960s and early 1970s. The growth of real output and productivity during the years 1974 to 1981 were all well below levels achieved earlier in the post-war period.

By 1980, the problem of inflation had become a major concern for the Canadian public and the number one concern of the U.S. public. While the proximate cause of the inflation was excessive monetary growth, the underlying reasons were diverse. They included the funding of the Vietnam War, the breakdown of the system of fixed exchange rates, the OPEC petroleum price increases, reliance on inflation-unemployment trade-offs in setting policy, confusion between real and nominal interest rates and insufficient appreciation of, or indifference to, the costs of inflation.

Paul Volker's appointment as Chairman of the Board of Governors of the Federal Reserve in August 1979 heralded a sharp break in monetary policy, one that would have substantial implications for the world economy and for Canada, in particular.[1] In his determination to contain inflation, Volker soon switched the Federal Reserve's operating target to slowing monetary growth, leaving interest rates to be determined by the market.

By the time of the Commission's appointment in October 1982, what was generally referred to as the great disinflation had a substantial impact on both the Canadian and U.S. economies: Both were in the midst of their second recession in two years. In Canada, unemployment averaged 11.1 per cent, and the Treasury bill rate was at 13.8 per cent after peaking slightly earlier at about 20 percent. The price level as measured by the consumer price index (CPI) grew at 10.8 per cent, down from its peak of 12.5 per cent in the previous year.

The future path of economic policy was far from clear during the early 1980s. Both the National Energy Policy of 1980 and the earlier Anti-Inflation Board had been substantial interventions into the workings of the economy. The April 1980 budget promised more through:

> [N]ew levels of government intervention to encourage Canadianization of the economy, the strategic use of the [Foreign Investment Review Agency], tougher rules for assuring government procurement contracts that would favour Canadian firms, and a new State Trading Corporation to help sell the products of smaller Canadian companies to centrally planned economies (Canada 1980).

Shortly afterward, however, a comprehensive high-tech industrial strategy proposed by Herb Gray, then the trade and commerce minister, failed to gain Cabinet support. The National Energy Policy, while still in place, and a more recent initiative for an energy-driven industrial strategy had been deflated by the failure of energy prices to meet projections. Some argued that apart from the existing wage-control program, Ottawa appeared to have nothing more in the way of economic policy than the Bank of Canada's determination to throttle inflation (Clarkson and McCall 1994).

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[1] See Feldstein (1994) and Mussa (1994) for detailed accounts of U.S. monetary policy in this period.

The Political Climate

Canada's economic performance was in the political spotlight to a degree unparalleled since the 1930s. An estimated 100,000 demonstrators braved cold, raw weather in November 1981 to protest high interest rates in a rally on Parliament Hill. Manifestos from different quarters decrying current economic policies received widespread publicity, including one from 50 Canadian economists in October 1982, condemning Canada's economic policies.[2] Canada, they declared, suffered more from the worldwide recession than other leading industrial economies. They said that misguided monetary policy had pushed interest rates and the Canadian dollar too high. They urged lowering rates by 2-to-3 percentage points; allowing the Canadian dollar to float without concern for its day-to-day level; replacing the government's existing wage-and-price control policy by a negotiated prices and incomes accord, and establishing a ceiling for profits, while giving greater income guarantees to labour. These measures should be accompanied by a moderate fiscal stimulus, the statement said. For dealing with possible side effects, the economists entertained policies such as a tax on repatriated interest and dividends to prevent a flight of capital.

Shortly after, a more surprising group — the Social Affairs Commission of the Canadian Conference of Catholic Bishops —

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[2] See *Statement of Canadian Economists*, October, 1982.

entered the economic debate. Their manifesto,[3] drawing from liberation theology, expressed concern about "the scourge of unemployment that plagues our society today and the corresponding struggles of workers in this country…."(Episcopal Commission for Social Affairs, 1982).

Prime Minister Trudeau thrust economic concerns further into the spotlight in October 1982 with three live appearances on national television:

> Our challenge is to restore Canada's fitness to survive economically in a world where the survival of the fittest nations has become the rule of life …(Clarkson and McCall 1994, p. 272).

He deplored the destructive consequences of inflation that:

> [C]ondemn [us] to live in poisonous distrust of each other, in pervasive disbelief that we are getting our fair share, in debilitating suspicion that everybody else is ripping us off (*Globe and Mail*, October 21, 1982, p. 2).

Viewing his government's limited anti-inflation initiative as a first step toward recovery, he firmly rejected comprehensive price and wage controls:

> Controls would not bring us together. They would drive us apart. That is what controls are for, to place the coercive use of government power between Canadians (*Globe and Mail*, October 21, 1982, p. 8).

He also rejected cuts in government spending in face of the high and increasing budget deficit and expressed concern about the deficits themselves because they testified to Canada's dire economic circumstances.

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[3] Cardinal Emmett Carter declared that the statement reflected the views of a committee consisting of just six of the 120 Catholic bishops in Canada and did not necessarily represent the Church.

Trudeau called for Canadians to pull together in their time of troubles (Clarkson and McCall 1994). This cure was less clear than his diagnosis and almost seemed to echo the bishops. Quite a different perspective is given by the Prime Minister's memo that soon followed to some cabinet members:

> Personally, I remain convinced that the primary engine of economic development must be a dynamic private sector and that the marketplace is in most circumstances the best allocator of scarce resources. The role of government must be to complement these functions...and where necessary supplement private initiative (Clarkson and McCall 1994).[4]

Clearly a change in view appears to have taken place with respect to the roles of government and the market in the two years since the budget speech of 1980. Still, a strategy relying on market forces had yet to be publicly articulated.

Within weeks of his TV appearance, the Prime Minister announced the appointment of the Royal Commission on the Economic Union and Development Prospects for Canada, with Donald Macdonald as chairman. The Commission's main elements were that it was overwhelmingly forward looking; that it had the objective of studying "the long-term economic potential, prospects and challenges facing the Canadian federation and its respective regions", and that it should examine and report on "the appropriate national goals and priorities" (Canada 1982).

The Commission's approach to growth and employment policy at all levels — the choice of objectives, the character of the policy framework and the detailed policies making up the framework — was coloured throughout by members' views about how much of an effect policy can have. Governments must recognize the constraints on policy, both national and international, and direct economic policy toward a medium- to long-term outlook.

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[4] Letter from Pierre Elliott Trudeau to certain cabinet members, July 6, 1981, cited by Clarkson and McCall (1994), p. 222.

Goals

Strong outside pressures made choosing among competing goals a highly charged issue for the Commission. Public opinion polls showed widespread concern about unemployment and many intervenors expressed more worries about employment than growth. However, the Commission resisted these pressures and immediately set out the touchstone of its approach: "Economic growth is fundamental to the maintenance of our standard of living" (Volume II, p. 3), effectively giving highest priority to this goal.

Sensitive to the public concern about employment, the Commission leavened the priority it attached to growth by conceding that "the claims of growth must be balanced against those of equitable income distribution, employment security, and environmental quality" (p. 3).

The Commission's choice of governing principles was heavily influenced by Canada's growth experience. Past industrial policies had shifted direction between "nationalistic goals and trade liberalization, development of a manufacturing sector or development from natural-resource wealth." No fans of planned development, the commissioners credited the lack of federal and provincial blueprints for industrial policy on "reliance on market forces and private sector-enterprise as the engine for growth", at the same time as they dismissed past policy for relying on "intervention too often, too intensively and in too ad-hoc a fashion" (Volume III, p. 381). They also considered the strategy of picking winners, and cautiously ruled out this option as unlikely to perform better than a more neutral policy, though they suggested monitoring and learning from the experience elsewhere.

The commissioners rejected the extremes of a highly interventionist industrial policy and a strictly hands-off policy. They favoured shifting emphasis from government intervention toward a more market-oriented approach. Overall, the general tone leaves little doubt that the shift toward the market should definitely be pointed towards the hands-off end of the spectrum:

Above all, the Commission supported its key recommendation that Canada seek a free trade agreement with the United States by referring to its potentially beneficial effects on economic growth.

Still, the advocacy of market-oriented growth did not blind the Commission to the need for government to provide programs to foster the effectiveness of the market mechanism. The Commission did recognize that government intervention may be needed in special circumstances, such as a clear market failure, substantial economies of scale, or where risks are excessive for the private sector. Such selective intervention should be used sparingly and should only take place when benefits exceed costs, using the least costly methods and only after consultation.

Any approach to employment policy was sure to be controversial. The "deep and traumatic recession" had made discussions of macro-economic policy highly charged (II, p. 3). The Keynesian macro-economic consensus that anchored activist fine-tuning was dissolving. Contrary views, previously overshadowed by the consensus, were steadily gaining support and moving to centre stage. In such circumstances, there was a risk that the Commission would succumb to steering a compromise path between the different viewpoints without any clear bearing.

The Commission came down firmly, though not unanimously, on one side of the debate.[5] Most recommendations reflected the recent developments in macro-economics that stressed the constraints and the limitations applying to stabilization policy:

1. It adopted the concept, if not the language, of the natural rate of unemployment, together with an estimate of the long-run level of unemployment that would seem to some to be overly pessimistic: The Commission urged that the issue of unacceptable levels of unemployment caused by structural problems be addressed by policies directed toward those structural prob-

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[5] Commissioner Clarence Barber, a professor of economics, objected to this choice, claiming: "The views expressed in the Report in this area may well reflect the views expressed in the Commission's research program. However, the profession is deeply divided on many of these topics and my own views differ substantially from those expressed in the Report" (III, p. 483).

lems: "For structural and institutional reasons, the rate of unemployment consistent with stable inflation in Canada is in the range of 6.5 percent-to-8 per cent. Expansionary monetary and fiscal policies cannot sustain levels of unemployment below this range over the longer term" (II, p. 388).

2. It accepted that stabilization policy should be aimed primarily toward the medium-term objective of price stability. In doing so, it rejected the view of the Keynesian consensus that short-term discretionary policy could be effective in maintaining a low and stable level of unemployment.

3. The Commission recommended maintaining a flexible exchange rate to preserve independence in domestic policy: At the same time, the Commission rejected the recommendations of the 50 economists to use exchange controls or an interest-equalization tax to achieve their different vision of a made-in-Canada policy: "Given our flexible exchange rate, we can choose our inflation rate in the long run and to that extent, we can have a made-in-Canada macro-economic policy" (II, p. 388).

4. The Commission recommended a gradual reduction of the government's deficit through a combination of tax increases and broad expenditure reduction. Commissioners also raised the possibility of reducing the index factor for taxes and discretionary transfer payments.

Incomes Policy

At some remove from the other analyses in both pages and spirit, the Commission supplemented its treatment of growth and employment by developing the case for an incomes policy.[6] Commissioners considered two arguments:

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[6] Clarence Barber had written a monograph advocating a three-year program of price and wage controls just prior to his appointment. See Barber and McCallum (1982).

- Decentralized setting of wages and prices is socially inefficient because workers and managers fail to take account of the inflationary impact of their decisions on others, and
- The market power of large corporations and unions leads to an inflationary bias in the economy.

These two arguments support quite different policy measures. The first, in the Commission's view, provided a case for only a temporary incomes policy; the second, if valid, justified the permanent use of an incomes policy.

The Commission rejected the argument for permanent controls because market power can explain only high prices, not the rising prices that constitute inflation. They took the first argument more seriously. While their analysis suggests that wage increases in excess of the growth of productivity are themselves inflationary — the mere act of bargaining over real wages is itself inflationary — the Commission does not explain the linkages through which this process takes place.[7]

In the final section on employment and growth, the Commission concluded that current conditions ("a deep and traumatic recession") were extraordinary enough to justify short-term stabilization measures to achieve "substantially higher employment over the next few years" (II, p. 376). To do so, commissioners proposed a changed policy mix:

> [A] shift to a less expansionary fiscal policy so as to reduce the deficit, should be more than matched by a temporary shift to a less restrictive monetary policy (II, p. 389).

Even though they conceded that inflation did not pose a problem at the time, commissioners still argued for a temporary incomes policy. While preferring a voluntary policy, they recognized that agreement may be difficult to reach and that "the prospects may be greater for achieving consensus in support of mandatory guidelines" (II, p. 377). Instead, they advocated broad cooperation among business, government and labour to achieve the needed consensus:

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[7] Such a link would appear to be based on either a theory of wage-push inflation, or a combination of inflationary expectations based on the rate of increase of wages and the validation of wage increases by the central bank.

> Without...a demonstration of political will by all major groups in society, and by individuals as well, the prospects for...major structural changes...would appear less bright. The basic challenge of political will is the central determination of improved economic performance (II, p. 391).

While short-term measures may have been justifiable at the time, the proposal appears at odds with both the analysis of incomes policy and the overall thrust of the report. One of the appeals of the commissioners' stress on longer-term goals and greater reliance on the market was that it could insulate the economy from what they saw as the effects of frequent, ad-hoc government intervention.

Conclusion

A policy vacuum existed in Ottawa during the early 1980s. The old post-war formula was well understood and had guided and shaped the policy process before it was undercut by the Prime Minister. His enigmatic plea to Canadians to pull together did not replace the old formula and could be read by different people in different ways. In this light, the purpose of the Commission can be viewed as finding a new guiding vision. As a result, its work on growth and employment should be judged on whether it created a new vision and what that vision is.

The commissioners provided a clear vision for growth and employment policy. They rejected the commitment to short-run stabilization that characterized much of post-war policy. They recognized that the long run was more than a succession of short runs, and that short-run actions can have unfortunate long-run consequences.

Such a vision provided an antidote to the over-selling of activist policies that took place in the 1960s and 1970s.

Acceptance of the vision was neither unanimous nor complete. Two members dissented strongly from it and two others expressed discomfort.[8] The Commission's treatment of incomes policy and the call for tri-partite cooperation appear to reflect quite a different viewpoint. The Commission also departed from its own approach in advocating the use of short-run stabilization measures in exceptional circumstances.

Overall, however, the Commission presented a vision that avoided promises that could not be kept. Its policy blueprint reflected the constraints and the limitations on policy imposed by reality. The questions of how well it has served Canada, and how suitable it is for the future I leave to my colleagues in this volume.

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[8] Barber was joined by Gerard Docquier, a leader of the United Steelworkers of America. John Messer and Laurent Picard expressed some discomfort with what they perceived as the polarization of the choice between government and market.

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Macro Stability and Economic Growth:
The Past 20 Years

Tim O'Neill

Reading the final report of the Macdonald Commission, it is clear that many of its recommendations have been acted upon. On the other hand, it is also clear that little in the Report — in its analysis or recommendations — was new at the time. This was the period when a transition in thinking about the role of government was underway, leading to a general conclusion that the role of government is to create an environment for economic success, not to control the economy. In the absence of the Commission, many of the recommended measures likely would have gone forward in any case. Yet the Commission also served to coalesce opinion, and to lend a sense of urgency to economic reform. As such, it represents a defining moment in Canadian economic history.

John Chant has very ably summarized what the Commission had to say about macro stability and economic growth. My assigned task is to discuss what has happened with macro stability and economic growth in the last 20 years. I focus on two aspects of Canada's macro-economic performance that have been resounding successes for the country, and two which have been less so. The two areas of significant achievement are both the result of macro policy adjustments: the taming of inflation, and winning the war on the deficit. The two areas of lesser success, while clearly relevant to long-term economic growth, are more the focus of micro policy efforts: reducing the natural rate of unemployment, and substantially improving productivity.

Taming Inflation

In general, Canada has had considerable success in improving the structure of its economy in the last 20 years. The recent Organisation for Economic Co-operation and Development (OECD) Economic Survey of Canada notes:

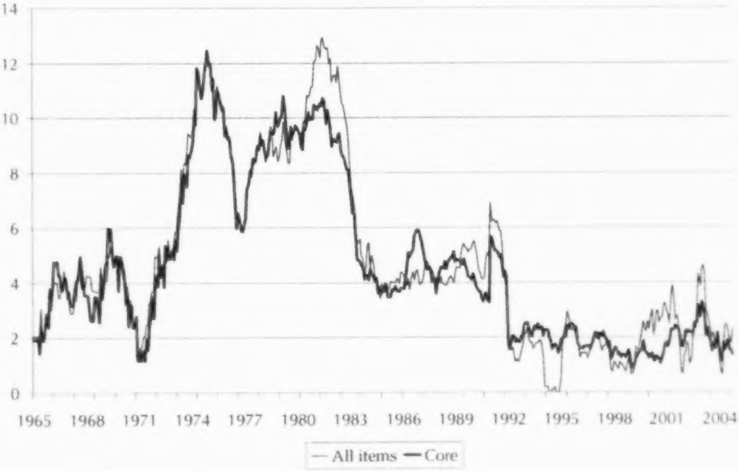
> The Canadian economy has delivered solid performance for nearly a decade with increased resilience to economic shocks, demonstrating the benefits of a well-designed macro-economic framework and the payoff from a range of structural reforms implemented since the late 1980s (OECD 2004).

Not the least of these successes has been the taming of inflation. Consumer price inflation topped 12 percent in 1981 and, though it had declined to 4 percent by 1985 (the year of the Commission's report), it was still considered by many to be too high. The acceleration of the rate of inflation in the 1987-1991 period to the 5-to-6 percent range indicated that the economy was still vulnerable. However, an incomes policy (wage and price controls), which the Commission had recommended be implemented if needed, was not the solution arrived at to eliminate the vulnerability.

Instead, the Bank of Canada and the federal government agreed to establish specific inflation targets — initially a range of 2 percent-to-4 percent in 1991, then a range of 1 percent-to-3 percent in 1993 — and the central bank adopted an aggressive policy stance to achieve them. On a monthly basis, with only rare exceptions, core inflation has remained in the 1 percent-to-3 percent target band since 1993. Overall inflation has breached the band somewhat more often (on a monthly basis), though on average, since 1993, it has averaged 1.8 percent. Not only has the inflation rate decreased, so has its volatility. The standard deviation of annual inflation rates over the previous five years is now only 0.4 percentage points, compared to almost 4 percentage points in the mid-1980s.

The reduction in inflation has allowed nominal interest rates to decline dramatically. Interest rates peaked in 1981 at over 20 percent at the short end (three-month treasury bills), and over 17 percent for long-term Government of Canada bonds (10 years and

Figure 1: *Consumer Price Index Year-Over-Year (% Change, Monthly)*



Source: Statistics Canada

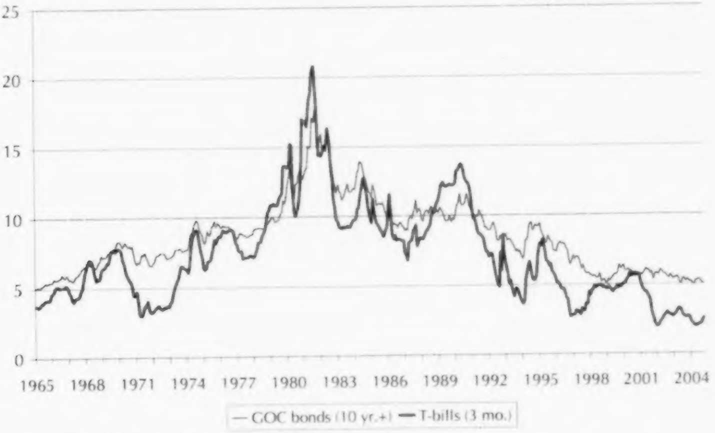
over.) By 1985, they had dropped significantly, but remained high — short rates were around 9.5 percent and long rates were around 11 percent. Rates have dropped sharply since then, averaging a little over 2 percent at the short end and a little over 5 percent at the long end in 2004.

Despite the not inconsiderable criticism of the Bank of Canada in the early 1990s, the taming of inflation has been one of Canada's great success stories. Canada now has a low and stable inflation rate and, barring a catastrophic memory loss on the part of the central bank, this is likely to be the case for the foreseeable future.

Winning the War on the Deficit

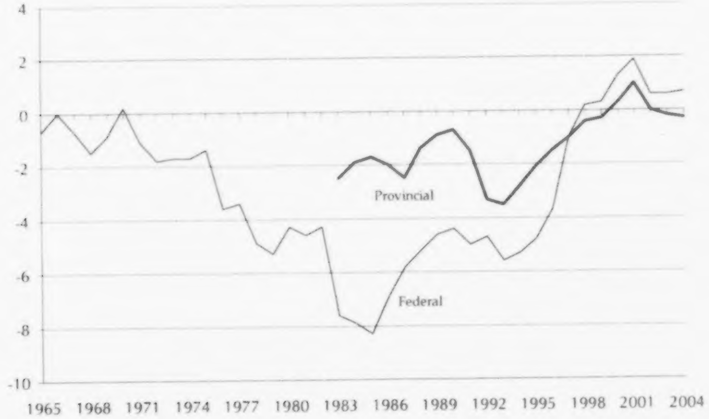
Another great success story for Canada has been the elimination of government deficits. On the federal deficit, the Commission rec-

Figure 2: *Interest Rates (%, Monthly Averages)*



Source: Statistics Canada

Figure 3: *Federal and Provincial Surpluses (Deficits) (% of GDP, Fiscal Year Ending March 31, 2004; Public Accounts Basis)*



Source: Department of Finance Canada

ommended gradual deficit reduction through a combination of tax increases and broad expenditure cuts.

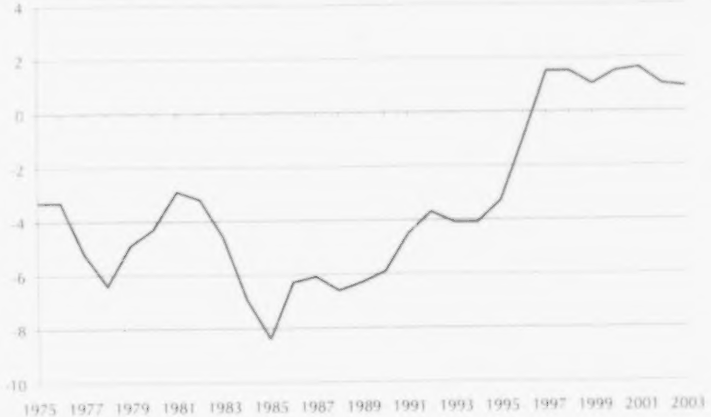
One possibility it suggested was partial de-indexation of some tax and expenditure items, such as setting indexation factors for personal income taxes and certain expenditure programs below the rate of inflation. Ottawa implemented such tax measures in 1986, with tax brackets and other income tax parameters increasing 3 percentage points less than the rate of inflation. (Full indexation of the personal income tax system was restored in 2000.) On the expenditure side, however, the efforts were less successful. The government partially de-indexed family allowances (those were the days before the Child Tax Benefit), but the attempt to do the same with Old Age Security met firm resistance from seniors' groups — and was abandoned.

Unfortunately, it was another decade and another recession later before Ottawa made a successful attempt to rein in the deficit. In 1984/1985, the fiscal year that had just ended when the Commission presented its final report, the federal deficit peaked at 8.3 percent of gross domestic product (GDP). It declined gradually through to the end of the decade to 4.4 percent of GDP by 1989/1990, then rose again to 5.6 percent of GDP in 1992/1993 as the recession of the early 1990s took its toll on revenue and the sharp rise in interest rates ratcheted up debt service costs. It finally became widely accepted that the deficit was structural, that the economy would not expand fast enough to eliminate it and, indeed, that if left unchecked, interest on the growing debt would spiral out of control.

After a half-hearted attempt at deficit reduction in his first budget in 1994, Paul Martin's second effort in 1995 represented the turning point. The federal budget was balanced in 1997/1998, and has remained in surplus ever since. Provincial deficits peaked at 3.5 percent of GDP in 1992/1993, but then began a gradual decline to balance, or near balance, in the years since.

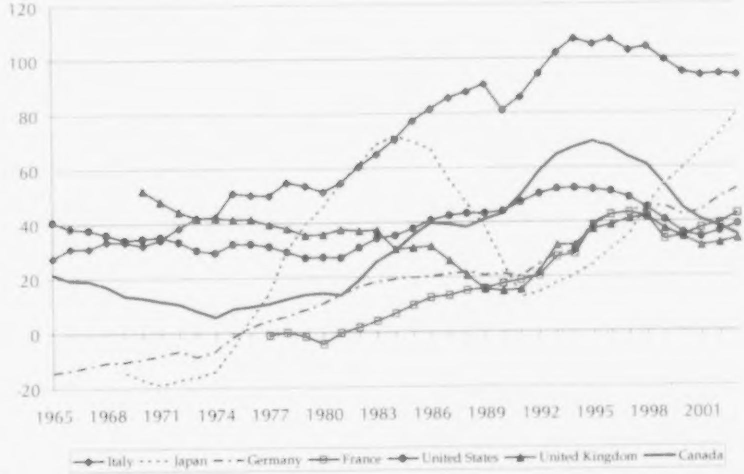
In 1982, Canada's debt (for all levels of government) was 19.2 percent of GDP, according to OECD figures. This was the third best in the Group of Seven industrial countries (G7) — higher than France and Germany, but lower than the U.S., Britain, Japan and

Figure 4: *Federal Structural Surpluses (Deficits)*
(% of GDP, National Accounts Basis)



Source: Department of Finance Canada

Figure 5: General Government Net Financial Liabilities
(% of GDP, National Accounts Basis)



Source: OECD

Italy. Three years later, the debt had almost doubled to 35.3 percent of GDP, and Canada had slipped to fourth place in the G7. By 1995, Canada's debt had almost doubled again, to 69.3 percent of GDP, and Canada's position had deteriorated to second worst in the G7. Since then, Canada's debt has declined to 34.9 percent in 2003 — the second best in the G7 — and OECD forecasts had Canada moving into first place by the end of 2004. Canada is currently the only country in the G7 running total government surpluses.

The improvements in Canada's inflation performance and fiscal health are truly remarkable. The country is now in a position to be able to respond to short-term economic shocks without having to worry about exacerbating long-term inflation or debt problems. Also, in the absence of short-term economic shocks, Canada is able to focus its attention primarily on addressing such longer-term concerns as productivity and demographics.

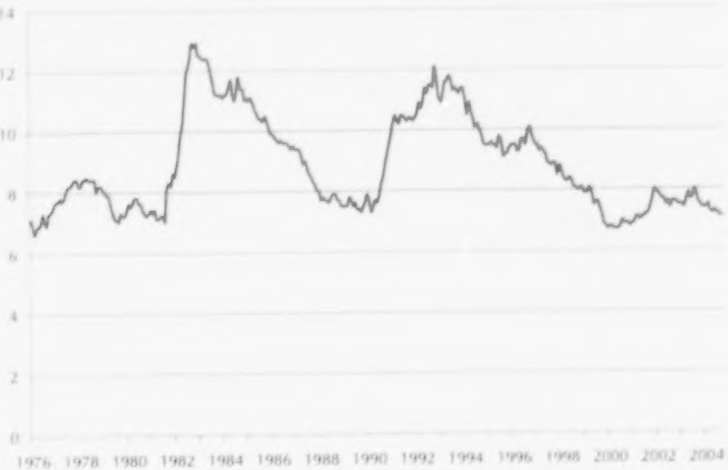
We turn now to two areas in which Canada has been somewhat less successful, though far from a failure. The first of these is unemployment. The second is productivity and living standards.

Unemployment

Canada has been very successful at reducing unemployment from the high levels of the early 1980s. At the time the Commission was established, the unemployment rate was at a high of 12.9 percent amid a recession in which GDP declined 4.8 percent from peak to trough. At the time, unemployment was seen as the single biggest problem facing Canada. When the Commission delivered its final report in 1985, the unemployment rate had fallen somewhat, but was still well above 10 percent.

During the boom of the late 1980s, the unemployment rate gradually drifted down to a low of 7.3 percent in early 1990. The recession of the early 1990s drove it back over 12 percent by late 1992. Labour market weakness persisted until 1997, with unemployment rates hovering close to 10 percent. Since 1998, however, the unemployment rate has been remarkably stable, varying between a low of 6.7 percent and a high of 8.1 percent. The current

Figure 6: *Unemployment Rate (%, monthly)*



Source: Statistics Canada.

unemployment rate of 7.3 percent (November 2004) seems positively utopian compared to the situation in the early 1980s.

However, this success has been almost entirely cyclical. With respect to structural unemployment, we do not appear to have made much progress. One of the unstated, though implicit, goals of the Commission was to recommend policies that would reduce the natural rate of unemployment, then estimated at 6.5 percent-to-8 percent. The final report of the Commission said that in the then-current environment:

> [It will be] very difficult to reduce unemployment, on a sustained basis, below 6.5 to 8 per cent....A long-term unemployment goal of less than 5 per cent is feasible but, in this Commission's view, only if Canadians support the necessary changes in policy and structural and institutional factors that influence the efficient allocation of resources (Macdonald Commission, Summary of Conclusions and Recommendations, 1985, p. 15).

Current conventional estimates of the non-accelerating inflation rate of unemployment (NAIRU) put it at about 7 percent, so a range of 6.5 percent-to- to-8 percent is a reasonable band within which to expect the economy to perform when it is at or approaching full employment. As a result, we would expect the unemployment rate to occasionally drop below that range in booms or rise above it in downturns. Over the last six years, as noted, the unemployment rate has varied between a low of 6.7 percent and a high of 8.1 percent. In these six years of fairly robust economic growth, (particularly in the 1996-to-2000 period) the unemployment rate has not once fallen below 6.5 percent. In fact, in the 29 years since the current employment survey was put in place, the unemployment rate has never breached the 6.5 percent level.

This lack of improvement is in sharp contrast with the U.S. record over the last decade. In the mid-1990s, typical estimates of the natural rate put it at about 6 percent. At the peak of the late 1990s boom, the unemployment rate bottomed out at 3.8 percent.It is now generally argued that NAIRU in the U.S. is around 5 percent. Even if NAIRU indeed had declined, the U.S. was able to achieve a rate much lower than that — something we have not managed in this country — without experiencing any significant acceleration in labour costs.

Living Standards — Canada *vs.* the United States

The other area in which Canada has been less successful is in its efforts to improve productivity/living standards.[1] We have tamed inflation, we have won the war on the deficit, we have created more jobs, but ultimately these are all means to an end — improving living standards.

The level of living standards has improved substantially since 1985. It is our relative performance on economic prosperity that has been, arguably, lacklustre. For example, real GDP rose 65 percent in Canada between 1985 and 2003. But real GDP increased almost 72 percent in the United States over the same period. Real per capita GDP rose 35 percent in Canada over this period, while rising by over 40 percent in the U.S. We have not closed the income gap with the United States — in fact the gap has widened slightly. In 1985, Canadian real per capita GDP was 88 percent of the U.S. level; in 2003, it was 86 percent.

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[1] Most of the data in this section are from the Canadian Centre for the Study of Living Standards. Where Canadian levels are expressed as percentages of U.S. levels, purchasing power parity exchange rates are used.

Real per capita GDP has declined only a little relative to the U.S. since 1985 because Canada has been better at creating jobs. Employment rose 35 percent in Canada between 1985 and 2003, while increasing only 29 percent in the U.S. As a result, however, when measured in constant U.S. dollars, real output per worker rose only 22 percent in Canada between 1985 and 2003, compared to 33 percent in the U.S. Real output per hour worked rose 25 percent in Canada since 1985, but 37 percent in the U.S. Output per hour worked has fallen from 91 percent of that for the U.S. in 1985 to 85 percent in 2003.

The results are even more dramatic when looking at personal income and personal disposable income per capita. Personal income per capita has fallen from 87.4 percent of that for the United States in 1985 to 78.1 percent in 2003. Personal disposable income has fallen from 80.5 percent of the U.S. level in 1985 to 67.7 percent in 2003.[2]

These differences in productivity and living standards are, I think, cause for some concern, particularly because free trade was supposed to, among other things, level the playing field between Canada and the United States by forcing Canadian companies to become more competitive. Increased economic integration was expected to bring about improvements in productivity growth. It is no small irony that opponents of free trade were concerned about the negative impact on jobs, while proponents touted the gains in living standards.

Daniel Trefler's contribution to this volume documents the extent to which each group over-stated its own case and understated that of the other.

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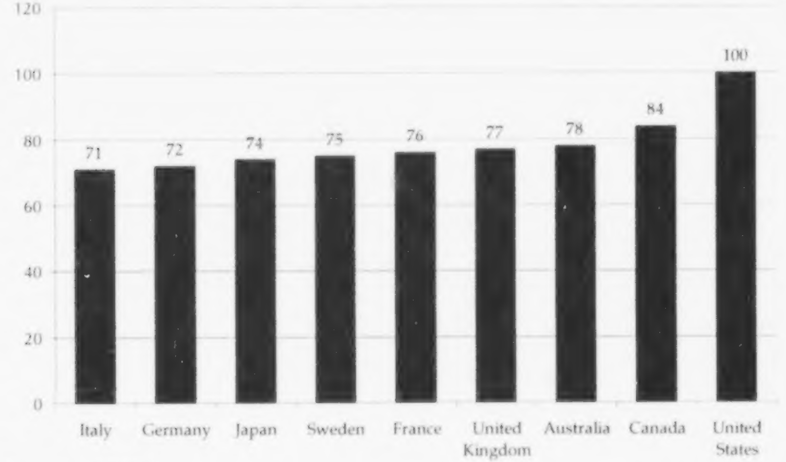
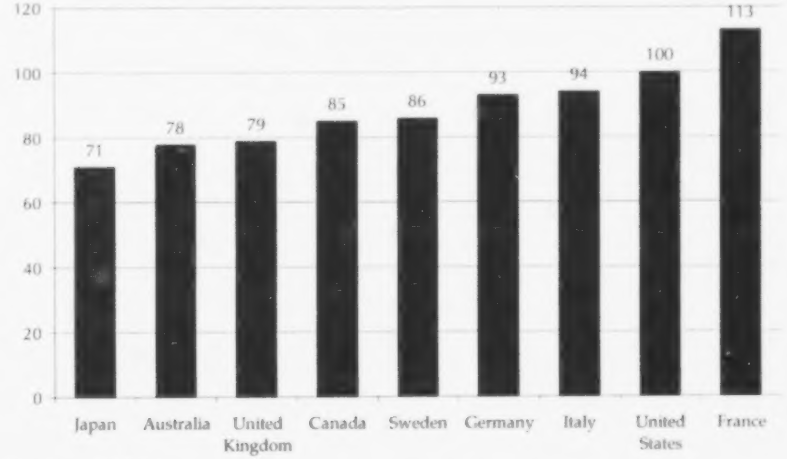
[2] For more on the Canada-U.S. productivity gap, see "The Canada-U.S. Productivity Gap", in Bank of Montreal, *Outlook 2004*, www.bmo.com/economic.

Figure 7: *GDP Per Capita (2002, U.S. = 100, Purchasing Power Parity Exchange Rates)*



Source: OECD.

Figure 8: *GDP Per Hour Worked (2002, U.S. = 100, Purchasing Power Parity Exchange Rates)*



Source: OECD.

Living Standards — Canada vs. the World

If we broaden the focus to the rest of the world, Canada's productivity/living standards performance presents a more mixed picture.[3] Figure 7 compares Canada to a peer group that includes the other G7 countries (the United States, Japan, Germany, France, Italy, and Britain), as well as Australia and Sweden. Using 2002 OECD data, with GDP converted to U.S. dollars at purchasing power parity, Canada's GDP per capita is second only to that of the U.S. (Within the OECD, only Ireland, Norway and Luxembourg exceed Canada, and only Luxembourg exceeds the United States.)

However, turning to GDP per hour worked (Figure 8), Canada fares less well, dropping to sixth place within the nine-country peer group. Notably, the United States drops to second. Apparently, some of the advantage that the United States and Canada have in GDP per capita is due to Americans and Canadians working more.

Over the last 20 years, the increase in Canadian productivity (measured as GDP per hour worked and converted to U.S. dollars at purchasing power parity exchange rates) is the lowest of any country in the peer group (Figure 9). Interestingly, those data show the United States to have the second lowest in the group. This raises some questions about the reliability of the data and the claims of a productivity miracle in the U.S. In fact, we should not place too much weight on international productivity comparisons, as there are many data and definitional problems. For example, much of the difference between Canadian and U.S. productivity growth may be attributable to different measures of quality changes used in constucting the two countries' statistics, particularly with regard to high-tech industries like semiconductors. We can also be suspicious of the data in Figure 8, which shows France to have by far the highest GDP per hour worked of the peer group. Nonetheless, the data do suggest worrisome patterns.

I think there are factors which may help explain why Canada's track record on unemployment and productivity has been rela-

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[3] The data in this section are from the OECD's Productivity Database.

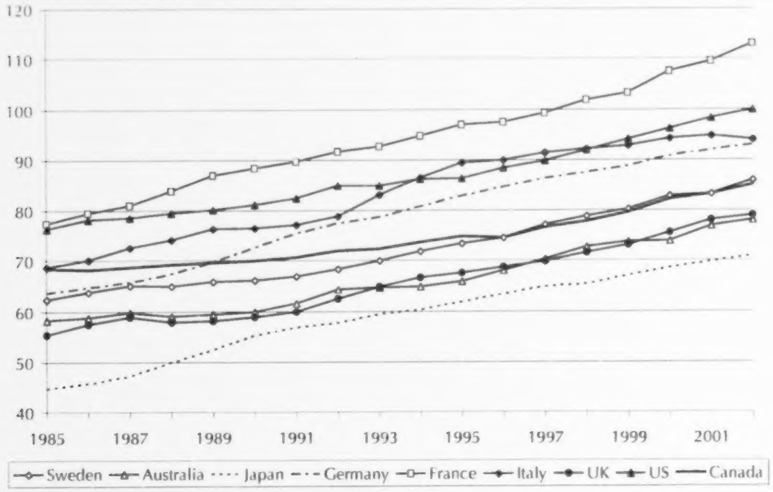

Figure 9: *GDP Per Hour Worked (1985=100, Purchasing Power Parity Exchange Rates)*

Source: OECD.

tively weak, and I want to link them to the Macdonald Commission Report. They relate to instances where the recommendations of the Commission were not adopted or were incompletely implemented.

Among these instances I would include the failure of government to act more fully on the Commission's recommendations on employment insurance (or unemployment insurance, as it was then called) which is dealt with at length in Jonathan Kesselman's chapter in this volume.

We should add to the list inadequate progress on the Economic Union. That is not to say that there has been no progress. The 1995 Agreement on Internal Trade represented a significant step forward. Indeed, there was some progress recently, with an agreement to open up supply contracts for federal and provincial Crown corporations and other agencies to bids from across Canada. But much work still has to be done, as there remain significant barriers to the flow of goods, services, labour and capital across provincial borders and very little sign of urgency or even interest in reducing them.

However, economists have had great difficulty in sorting out the key factors which explain the significant change in productivity growth that we have witnessed over the last 60 years. High rates of productivity growth from the early 1950s to the mid-1970s were followed by sharply lower growth rates among all advanced economies until the mid-1990s. We have considerable debate even over the appropriate measures on which to focus, and on the methodology for estimating productivity when we decide on the measures.

As a result, we have a limited consensus on what to advise the government to do to improve the country's productivity. Directionally, we are confident that removing impediments to investment by, for example, reducing taxes on capital, can have a positive impact. Enhancing the stock of human capital — a variety of means are possible — should add to the standard of living at least for individuals whose assets have improved. But the evidence on actual results is spotty, at best, and we are often left in the position of arguing against public policy measures that will adversely affect productivity and the functioning of the labour market, rather than persuasively arguing for positive steps which can be taken.

In sum, we have made real progress in Canada on macro stability and growth by achieving and maintaining low inflation and by establishing credible fiscal discipline. We have much more room for improvement in the areas of productivity/living standards and structural unemployment. In other words, we have had considerable success in the judicious use of broad macro policy and are enjoying the credibility in financial markets that accompanies such success. It is in the adjustment of micro-economic policy that we have to improve.

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Macro Stability and Economic Growth:
Lessons for the Future

Grant Reuber and William Robson

The federal government's macro-economic policy which, for our purposes, refers to monetary and exchange-rate policy, as well as fiscal policy, helps set the environment in which households, companies, and other levels of government carry on daily life. That environment affects the allocation of resources, determines the level of aggregate employment, output, saving and investment, and influences how quickly those aggregates grow over time. Modern governments have powerful tools to influence this environment. Previous chapters have reviewed what the Macdonald Commission Report said about how macro-economic policy could improve Canada's economic performance and how its tools were in fact deployed and with what consequences since then. This paper's task is to identify lessons for the future from that experience.

The Report's discussion of monetary and fiscal issues is less a bold step forward than a nuanced synthesis of views then current among many academics and public commentators. While Clarence Barber — who tended toward what nowadays would appear to be a hard-left Keynesian position — registered an overt dissent from many of its recommendations, the Commission's qualified language accommodated much of what Barber proposed. It is striking, re-reading it after 20 years, to see how effectively the Report synthesized a conflict-filled debate preoccupied with cyclical slack in the economy in a way that would earn it a serious hearing among policymakers and the public. From today's perspective, these preoccupations and the synthesis they inspired make the Commission's work both impressive and frustrating.

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* We thank David Laidler for comments and discussion.

In some respects, experience and advances in theory since the Report's release offer promising ideas about confronting today's macro-economic challenges that go beyond what the Commission contemplated. In others, both the Report's successes and its failures lead to more modest conclusions about advances in economic policymaking. In monetary matters, substantial improvements in the framework of policy have occurred in the wake of the Report. In fiscal policy, the framework remains unsettlingly undefined. A modern-day equivalent of the Macdonald Commission might usefully enhance its capacity to define a robust fiscal framework by focusing, not on cyclical issues, but on the factors affecting long-run growth and sustainability.

The Circumstances of the Commission's Work and Recommendations

The decade that led up to the Macdonald Commission's work and Report featured major failures in monetary and fiscal policy, as John Chant and Tim O'Neill show in some detail in their contributions.

On monetary matters, the Bank of Canada had acknowledged its responsibility for inflation in 1975 and undertaken to reduce it by gradually slowing the growth rate of the money stock as measured by M1. The Bank abandoned this policy of gradualism — both the money target and the gradual approach — around the turn of the decade. From 1978 until early 1984, monetary policy was ill-defined, but appeared to be driven largely by a desire to steady the foreign-exchange rate as the United States went through two major periods of rising interest rates. In 1984, Ottawa let the dollar fall and policy became more accommodative: The trend in inflation during the rest of the decade was generally upward.

The outstanding feature of the fiscal landscape at the time of the Commission's Report was federal deficits large enough to produce a steady increase in the ratio of public debt to national output. The ratio of net federal debt to gross domestic product (GDP) had reached a post-war trough below 20 percent in 1975, and although the ratio still was below 40 percent at the time the Commission was writing, the arithmetic of primary deficits and compounding interest payments showed clearly that the direction for the foreseeable future was up. Conservative Finance Minister John Crosbie's ill-fated 1979 budget responded with an attempt to refocus macro-economic policy:

> Our recent economic experience proves again that simply printing money and increasing government expenditures and the deficit does not help. Such actions only make matters worse. A disciplined and realistic fiscal and monetary framework is essential. (Department of Finance 1979).[1]

Longer-term revenue and expenditure projections in the budget provided evidence that this was not just rhetoric. How this approach might have fared is a matter for conjecture: Within months a new government with a starkly different approach was in place, and another decade passed before major fiscal consolidation occurred in an environment of much lower inflation and more debt-sensitive financial markets.

Merits and Shortcomings in the Report's Recommendations

As these thumbnail sketches suggest, macro-economic policy during this period was notable for its lack of defining principles that would enable households and businesses to plan with confidence. Both monetary and fiscal policy were steering between the waves rather than using a compass. The Commission described these problems, but had difficulty outlining convincing remedies.

Monetary policy is the easier of the two to discuss, especially in light of the dramatic increase in precision about its objectives and about the role and operations of the Bank of Canada that occurred during the following decade. The Commission endorsed Canada's flexible exchange-rate system for the independence it provided domestic policy — a position the Report happily did not qualify.

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[1] Readers with very long memories will recall that one of us was deputy minister of finance at that time.

When it came to the appropriate use of the independence thus gained, the Report was less clear. One of its more interesting suggestions was targets for the growth of nominal national income. Such a regime would have similar long-run properties to one using a price-level-related target. The Report did not, however, pursue this idea far enough to present a concrete proposal.

Notably, the Report made little contribution to assessing the costs and benefits of inflation. It concluded its discussion of inflation and economic performance by saying that widespread moves to bring inflation down in the advanced economies "did not reflect conclusive new evidence of the adverse effects of inflation on economic performance", but "rather a widespread judgment ... that to accommodate high and rising inflation was no way to run an economy" (Volume II, p. 289).

Finally and perhaps most importantly, the Report's discussion of the vital role of expectations in determining inflation, and of the concomitant need to change expectations to achieve price stability and improved economic performance, was partial. Expectations of inflation did figure in the Report's discussion of where inflation comes from and what might be done about it. But the Report's recommendation for more indexing and its support of temporary incomes policies as a complement to easier money in aid of deficit reduction signaled reluctance to follow its own logic far in this matter. Nor did the Report give much consideration to financial markets, which are decisively influenced by expectations of both monetary and fiscal policy, and which were to demonstrate their power to discipline policy markedly in the following two decades.

What about fiscal policy? The Report's recommendations in this area rested firmly on national accounting that relates output to major elements of expenditure, and focuses on the allocation of income between consumption and saving, with particular attention to whether investment will equal saving when the economy is operating at capacity output. The Commission argued, and Barber's dissent forcefully amplified this view, that there was "too much saving" to propel the economy to full employment. The remedy was less saving — more government spending to make up for the excessive tendency by the public to save and the excessive reluctance of businesses to invest. Over time, higher taxes, through partial de-indexation of the personal income tax, and monetization would limit the impact of this fiscal stimulus on the trajectory of the federal debt.

This national accounting arithmetic tells us nothing about the factors determining investment and consumption, including the major role of expectations. Again, lack of concern about how people form and act on economic expectations is conspicuous in the recommendations — one might note, for example, that an environment in which taxes are expected to rise over time is uncongenial for higher consumption and investment.

Anticipating some of our later comments about setting a macro-economic framework today in the light of the experience of the last 20 years, another important element not addressed by the Commission is the growth of programs for which costs are shared between the federal and provincial governments. By the early 1980s, experience had shown that shared-cost arrangements create strong incentives to add to spending. Experience had also shown that the new programs tend, once they have burgeoned, to be deemed unaffordable, with the consequence that the federal government then cuts its support, leaving provincial finances in dire straits.

Finally, and not coincidentally, we note the Report's strong focus on short-term cyclical concerns at the expense of long-term growth issues.

The Report's observations on the joint use of monetary and fiscal policies to fine-tune aggregate demand show the impact of a decade of disappointments. Interactions with the world economy, information failures, institutional rigidities and expectations, "rational or otherwise", all merited mention in its sobering assessment. And yet the Report recommended, as noted, using monetary policy in a compensatory role for fiscal policy, so that easier money would offset the impacts of tighter fiscal policy on demand. Concern about effects on demand also led the Commission to endorse gradualism in general, with both monetary and fiscal changes being applied slowly.

The experience of the following two decades admittedly provides some examples of monetary-fiscal offsets along the lines the Commission anticipated. In general, however, it seems safe to say that thinking has become more skeptical about active demand-management through fiscal and monetary measures combined. This heightened skepticism arises partly from deeper appreciation of tactical difficulties, such as those that arise from time-lags, both in gathering and assimilating information about the world, and in acting on it fast enough. Also contributing to it is a view that the very different nature of the instruments that monetary and fiscal policy deploy makes separate targets for the two apt, and that separating monetary from fiscal strategy improves the prospects for long-term growth and sustainability.

The Report's discussion of fiscal issues and sustainability makes surprisingly little reference to long-term developments. The social policy sections of the Report make some mention of demographics, including the desirability of gradual contribution-rate increases in the Canada Pension Plan (CPP), rather than the sharper increases that a rapidly shifting balance of contributors to recipients would otherwise produce. But the evolving position of the CPP and the Quebec Pension Plan (QPP) in the overall national saving picture, and their implications for the public sector's future balance sheet, do not figure — an omission obliquely noted in Barber's dissent, although his main focus was on the implications of level or shrinking populations for economic growth. And while the Commission's recommendations on free trade were, as noted by Gil Winham in this volume, intended to move the Canadian economy to a higher level of efficiency, research into endogenous growth models still lay in the future. The Report had nothing to say about policies that might affect the growth rate of productivity — which historical experience has shown to be the most important influence on living standards in the long run.

Requirements for a Sustainable Macro-Economic Framework

That observation provides a natural segue to the question of what lessons for the future we can draw from this experience. To repeat a point made at the outset, federal macro-economic policy creates the framework within which households, businesses, and other governments conduct their affairs. If that framework is to promote an allocation of resources that is efficient at a point in time and promotes growth in living standards over time, it needs to be stable. And to be stable, it needs to be internally consistent and supported by the population, at least to the extent of not being politically fatal to governments that maintain it.

As Tim O'Neill's account of the intervening years emphasizes, monetary policy has moved in a direction that conforms to these requirements much better than was the case in the early 1980s. Inflation targets, first introduced in 1991, have, for almost a decade, specified that the goal of monetary policy is to produce year-over-year inflation, as measured by the consumer price index, of 2 percent. This is a goal the public can readily understand, and the incentives affecting those charged with implementing it are evidently consistent with the kind of rigorous and successful pursuit of the target that builds confidence in its durability.

Two major issues about the monetary framework remain. One is whether the existing regime is close enough to price stability. If the consumer price index measures inflation accurately, 2 percent compounding over 30 years reduces the purchasing power of money by about one-third — an amount that is sufficient to impede the functioning of such markets as those for long-term capital investments, mortgages and annuities. Another is whether targeting annual changes in the price level is rigorous enough, or whether a target that referred to the path of the price level itself would serve Canadians better. The inflation-targeting regime ignores past mistakes and allows base-drift; a level-referencing regime would have to correct them and, in a technical sense, would provide as much certainty about the price level 30 years from now as three years out.

From these two major issues a third naturally follows: whether these defects are serious enough to warrant reopening the monetary-policy debate. Reasonable people can differ on that subject. A defensible position would be that — barring a deepening of North American economic and political integration to the point where a continental currency became an alternative worthy of such a debate — the political capital the debate would require can best be deployed to some other purpose.

Establishing a comparably well-defined fiscal-policy framework would be one such purpose. Fiscal policy is inherently more complex than monetary policy. Central banks have one tool — the terms on which high-powered money is available to the financial system — and can use it in pursuit of only one target. Fiscal policymakers have many tools, including different taxes and spending programs, and can therefore pursue many targets. That difference noted, the advantages of a well-thought out mid-term fiscal strategy are illustrated by experience in the second half of the 1990s, when the federal government was finally forced to face up to its chronic debt problem. The government set out a fairly clear mid-term fiscal framework to improve Canada's economic and financial performance, and stuck with it. The results were impressive and eventually widely accepted by the public. Almost a decade later, however, it is clear that the incentives to pursue that course were contingent on the circumstances of the time and federal fiscal policy has since begun to drift.

The essence of the challenge is to set some key parameters to establish a fiscal environment within which the private sector and the public sector outside the federal government can function with confidence. One approach to deciding what those parameters might be is to conceive of a hierarchy of objectives, each of which allows some freedom in choosing those at the next level.

The CPP, conspicuous for its light treatment in the Commission's Report, might provide guidance when it comes to an overarching objective. Stable fiscal policy must respect budget constraints. A critical target of the CPP reform package introduced in 1998 was to establish a sustainable contribution rate — a criterion satisfied in that case by a requirement that the specified rate yield a projected ratio of investments to annual expenditures that is the same at two target dates 50 years apart. In the federal government's case, a comparable exercise would involve projecting expenditures and revenues using status quo policy assumptions, and targeting a given level for the ratio of net debt to GDP.

To be effective, such a framework would have to elicit adjustments in taxes or spending when changing circumstances or new budgetary initiatives put the projected ratio off target. That, in turn, would require incentives for policymakers to make the adjustments rather than to junk the regime. Such a framework would be an important advance on the current federal target — mentioned in the 2004 budget, but unsupported by any further action – to reduce the debt-to-GDP ratio to 25 percent within 10 years. Canadians are entitled to skepticism about how readily a sustainable debt target could be communicated to the public and about how readily the public and Parliament would seek to hold successive federal governments to it. The CPP provides some hint that a promise of a sustainable regime is one that resonates with the population, however, and the fact that demographic change requires advance planning is not controversial today.

Moving to the next step in a potential hierarchy, it would be possible to establish expenditure parameters related to federal responsibilities for defense, border security, foreign aid, and related matters. Other candidates relate to levels for specific taxes — encouraging more straightforward discussion of the merits of taxing personal incomes versus personal consumption, for example, or levying taxes on such other bases as business income or property values. Perhaps the federal department of finance could overcome its longstanding aversion to dedicated taxes for the sake of achieving long-term sustainability in specific programs with earmarked financing.

More critically, explicit consideration of such issues in a long-term framework would direct attention to the growing body of theory and evidence about what kinds of taxes and programs are most supportive of long-term growth. The losses imposed by economic cycles of the amplitude that Canada has experienced over the past two decades are orders of magnitude smaller than the losses imposed by policies that reduce the growth rate of productivity and living standards. Research comparing fiscal policies and growth rates across countries, such as that by Bleaney et al. (2003), appears to confirm what theory suggests: that taxes on consumption support growth better than taxes on income, especially taxes on capital income, and that public investments in infrastructure, health and education support growth better than transfer payments do. Cross-country experience also testifies to the political feasibility of many different configurations of taxes and spending programs, and it is reasonable to suppose that configurations that support more rapid rises in living standards will prove more durable over time.

A particularly thorny problem in setting a stable and politically sustainable fiscal framework arises with regard to shared-cost programs. Without broad but well-defined policy frameworks, both the private sector and the public sector function in a world that is more uncertain than it need be, and shared-cost programs are notorious for confronting policymakers with incentives that work against medium- and long-term stability. Current discussion of a national child-care program shows that such systemic considerations are no bulwark against new policy adventures when no generally accepted guidelines exist to warn of their dangers. Our principal suggestion, and in this we anticipate several observations by Geoffrey Hale in his chapter, would be to avoid such arrangements. The more closely each level of government's spending responsibilities match its revenue capacities, the better voters, whether as the beneficiaries of public programs or as taxpayers, can determine who to reward or punish. When better alignment of incentives along those lines is elusive, an alternative is formula-driven arrangements designed with explicit attention to long-term sustainability. That is an approach that one of us has proposed to fund federal-provincial health transfers that are sensitive to the pressure of an aging population (Robson 2001).

Finally, the pursuit of a stable long-term framework leads to some important observations about expectations and about gradualism and fine-tuning.

Clearly, the benefits of a stable framework arise largely from the ability of households and companies to plan with confidence. Gradualism, or a program that seeks to use monetary and exchange rate policy on the one hand, and fiscal policy on the other, as complementary tools for short-term management of aggregate demand, are not conducive to such an environment.

The fact that the fiscal pressures of the mid-1990s did not plunge Canada into recession suggests that the promise of a sustainable mid-term path mattered more than any short-term impact on demand. Monetary policy under inflation or price-level targeting is a powerful stabilizer with a long-term anchor. With that in place, fiscal policy should not allow short-term cyclical objectives to compromise longer-term goals that promise high and rising living standards.

Could We Do Better Today? A Cautionary Comment

To sum up, the Commission's Report provides important pointers to current and future economic challenges, both when it appears to have been on the mark, and when its aim was less reliable.

In commenting on how we might recast its recommendations on macro-economic policy today, we appreciate the powerful influence of subsequent experience, and some of the new thinking, particularly on long-term growth, that was not available to the authors of the Report. Those considerations ought to make anyone looking ahead from today cautious about claiming that the work of a present-day commission would stand up notably better under the scrutiny of a comparable volume to this one 20 years hence.

While we are confident in the recommendations that we have made about the underpinnings of a sound macro-economic framework, we are also conscious of the challenge of crafting prescriptions that embody the most rigorous analysis available and at the same time command enough support among policymakers and the public to make it out of print and into practice. The Macdonald Commission set a standard in that regard that any modern day equivalent would do well to match.

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Labour Markets and Social Policy: What the Macdonald Commission Said

W. Craig Riddell

The Macdonald Commission's views on labour markets and social policy were based on its members' assessment of the "common goals and values with which Canadians approach these programs" (Volume II, p. 537). These included efficiency in the use of scarce resources; equity in the distribution of rewards in society; security in the form of protection against adverse developments; opportunity for upward mobility; individual responsibility to provide for ourselves, and sharing of risks and rewards in a complex and dynamic economy. Balancing these competing objectives is a central preoccupation in this section of the Report.

In summarizing the Commission's wide-ranging views on labour markets and social policy, it is tempting to focus on the headline recommendations, such as proposed reforms to unemployment insurance, adjustment assistance programs and income security policies. However, this approach is arguably too narrow. Much of the Report consists of diagnosis rather than prescription, and its influence may have flowed from its detailed diagnoses, as well as from the specifics of its recommendations. Furthermore, some prescriptions, such as those relating to minimum wages and pay equity, advised what not to do, as well as what to do.

In this paper, I do not attempt to assess the influence of what was said, a task that is left to other chapters in this volume. I do, however, conclude with some observations on the correspondence between the Commission's analysis and recommendations and subsequent developments.

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* I thank David Laidler and Bill Robson for comments on a previous version.

Evolution of Social Policy

Chapter 14 reviews the evolution of the welfare state in Canada during the post-war period and compares Canada's experience to that of other industrialized countries. This section also examines evidence on the welfare of Canadians, such as changes in average living standards and income distribution. This section of the Report is heavy on diagnosis and light on prescription. However, some conclusions reached here have implications for recommendations made subsequently, especially those relating to income security.

At the time, there was debate about a possible crisis of the welfare state. This concern reflected the apparent inability of many European economies to adapt to a changing economic environment, a phenomenon often called Euroschlerosis. As in Europe, the Canadian welfare state expanded significantly during the post-war period. The commissioners' assessment was that there was no evidence that Canada's expenditure on social programs was excessive or unmanageable. However, the Report was critical of the composition of social spending and the design of specific programs.

Several other points were highlighted in the review of the evolution of social policy. The distribution of income had been very stable in Canada during the previous three decades. As a result, the forces that were widening income inequality, which dominated subsequent research and policy debate, were not yet evident. Commissioners also emphasized that poverty remained an important problem in spite of the expansion of social programs. Particular note was taken of child poverty and the problems facing the working poor. As the Report said of the working poor: "Theirs is a plight too often ignored" (p. 569). These features of poverty played an important role in the recommended income security reforms.

At the same time, three key pressures on the welfare state were identified. One was population aging, a pressure that was viewed as sufficiently far off that there was time to take appropriate actions. The second was the possible incompatibility between the welfare state and a vibrant economy. In that regard, the Report argued, the challenges arise not so much because of the level of expenditure, as because of the design of specific programs. This section foreshadows the position that the Commissioners would subsequently take: a radical redesign of Canadian social programs, while staying within the existing expenditure envelope. The third pressure was inherently political — the post-war consensus on social policy had given way to more active ideological debate and uncertainty. An assessment of the views of individual Canadians revealed, however, no shift in opinion about the role of social security in a modern society.

Functioning of Labour Markets

This long chapter contains a wide-ranging assessment of labour market performance in Canada. It begins with an extended discussion of prevailing views about causes and consequences of unemployment. Unemployment was a priority issue at the time. In part, the high jobless rate reflected the temporary effects of the 1982/1983 recession. However, unemployment had also drifted upwards during the 1960s and 1970s and the base level appeared to have risen.

An important concept introduced earlier in the Report was the notion of a non-accelerating inflation rate of unemployment (NAIRU). By this time, the view that there was a short-run, though no long-run, tradeoff between inflation and unemployment was widely accepted in the economics profession. However, the belief that macro-economic policy could not permanently reduce unemployment below 6 percent-to-8 percent (the estimated NAIRU at the time) without risking accelerating inflation had not yet become part of commonly accepted wisdom. This shift away from traditional Keynesian beliefs to a more classical perspective was one of the most profound messages in the Report's sections on macroeconomic policy.

The importance of the NAIRU concept was repeated in the section on labour markets, with a more hopeful tone. Specifically, the Report pointed out that the NAIRU is not a fixed level, but one that "can be lowered by the intelligent application of policies such as training, education, mobility grants and other adjustment programs, and by the careful design of our major income-transfer systems" (p. 587). Reducing prevailing levels of unemployment was to be another objective of reforms to labour market and social policies. Commissioners acknowledged this shift away from Keynesian prescriptions for lowering unemployment: "[T]o deal effectively with the unacceptably high levels of unemployment of the 1980s ... it is our conviction that the easy nostrums of the past will not provide effective guideposts for the future" (p. 587).

At the same time as macro-economists were altering traditional views about the relationship between inflation and unemployment, labour market research was changing views about the nature of unemployment. The new unemployment perspective placed more emphasis on the dynamic nature of the labour market. Rather than regarding the unemployed as a stock of workers awaiting an upturn in economic activity, researchers increasingly regarded unemployment in dynamic terms. As a result, ameliorative policies placed more emphasis on reducing employment instability and job turnover, facilitating job searches, and improving labour mobility and adjustment. The Report also noted the possibility that such policies as unemployment insurance and minimum wages may have adverse side effects that increase joblessness.

The discussion of unemployment was followed by a detailed assessment of Canada's unemployment insurance (UI) program. This review examined the objectives of UI, the evolution of the program, and its consequences for unemployment and labour market adjustment. The Report said that the UI program had initially focused on social insurance objectives, but had gradually moved in the direction of income redistribution objectives, as well.

This shift was regarded as being unwise:

> This Commission is vitally concerned with poverty and, more generally, with the distribution of income and opportunity among Canadians. Our view, however, is that income distribution does not constitute an appropriate application of the UI system (p. 602).

This view, together with the evidence on the labour market consequences of the UI program, greatly influenced the Commission's recommended reforms to UI. The assessment of the consequences of UI for unemployment and labour market adjustment was largely negative:

> On reviewing the evidence compiled by a number of researchers, commissioners concluded that the unemployment insurance program: contributes to an increase in the duration of unemployment; increases the volume of temporary layoffs; reinforces the concentration of temporary and unstable jobs in high unemployment and low-wage regions; and provides too generous a subsidy to Canadians whose labour force behaviour is characterized by repeated unstable employment (p. 610).

The proposed reforms were extensive. On financing, the Report recommended experience rating of individual companies, which was regarded as "the most important change that should be made to Canada's existing UI system" (p. 611). On benefits, the recommendations included: reduced benefit rates; higher entrance requirements; tighter links between the maximum benefit period, and the minimum amount of work required to qualify for benefits, as well as elimination of the regional differentiation of the UI program.

Commissioners also recommended the introduction of a Transitional Adjustment Assistance Program (TAAP). Building on the view that the existing UI program created barriers to adjustment, TAAP was intended to encourage positive adjustment to changing labour market opportunities and to reinforce the proposed UI reforms. TAAP would be available to those who had exhausted their UI benefits or whose layoffs appeared permanent even if benefits were not exhausted. The main elements would include on-the-job and institutional training, portable wage subsidies, mobility grants and early retirement plans. Together, the proposed UI changes and the introduction of TAAP were expected to improve labour force adaptability. Major changes to the income security system would complement the changes to UI and adjustment assistance.

The Commission also examined minimum wage policies. Commissioners said that minimum wages should be assessed primarily on the basis of their ability to help the working poor. Using this criterion, several problems with minimum wages were identified: adverse employment effects; reduced training opportunities, and less wage flexibility in the economy. The Report recommended de-emphasizing minimum wages as a policy instrument, placing more reliance on supplementing incomes of the working poor through the tax and transfer system, and improving training opportunities to raise worker productivity and earnings.

Commissioners gave substantial attention to equal opportunity and equal pay in Canada's labour market. The Report notes the depth of concern expressed in the hearings and briefs relating to discrimination and the need for greater equality of opportunity. As a result, the Report contains a detailed discussion of the sources of the male-female wage gap and the policy options that might be pursued to narrow the differential. Although supporting further government intervention in this area, the Report expresses caution about the use of equal pay for work of equal value (subsequently called pay equity). More generally, commissioners cautioned against replacing market-based pay determination with administratively based pay systems. Instead, the commissioners recommended greater use of affirmative action or employment equity programs. The rationale here is similar to that expressed regarding minimum wages: Rather than impose higher wages at existing levels of labour demand and risk adverse employment consequences, policies should attempt to raise labour demand among targeted groups.

Immigration

The chapter on immigration is surprisingly brief. Still, it does touch on many central issues and makes a number of recommendations. The Report correctly anticipates that the shift toward immigration from non-European countries will continue and that this change will have important implications for Canadian society. Problems with existing methods of selecting economic migrants are discussed. The recommendation to "place more weight on general labour-market skills and less on narrow occupational requirements" (p. 668) was subsequently reflected in Canadian immigration policy. In addition, commissioners recommended adopting a less restrictive immigration policy than the one then in place and moving gradually toward higher levels of immigrants. At the time, net immigration was approximately 50,000 people annually, so this suggestion was clearly adopted. Indeed, throughout the period 1985-to-2000, Canadian immigration levels rarely fell below 200,000 a year.

Canadian immigration policy had traditionally been based on the notion of the absorptive capacity of the labour market. Accordingly, permitted inflows tended to be restricted during economic downturns. The Report's recommendation to "set immigration levels on the basis of long-term objectives, rather than on that of short-term considerations" (p. 668) could be seen as a reaction to this approach. This recommendation may have helped to set the stage for the decision not to restrict inflows to a significant extent during the severe recession of the early 1990s, a policy decision that remains controversial.

Interestingly, the Report comments that immigration represents an area of "public policy which commissioners perceive as being little debated, under-researched, and extremely important" (p. 668). Subsequently, the situation changed dramatically. Immigration became an active area of research and public debate. The research, in turn, revealed the poor economic performance of recent immigrant cohorts, a phenomenon that was not apparent at the time.

Labour-Management Relations

The long chapter on labour-management relations covers such topics as public sector labour relations, strikes and lockouts, mechanisms for promoting labour-management cooperation, and workplace health and safety. The contrast between this chapter and that on immigration is striking. In the immigration area, the Commission's diagnosis was brief and its prescription substantial. Immigration subsequently became a very active area of research and public debate. In labour-management relations, the diagnosis was lengthy and the prescriptions relatively minor. Labour-management relations subsequently became a relatively inactive area of public debate and research.

These differences largely reflect subsequent developments. Immigration levels rose dramatically after the mid-1980s and remained high. In contrast, unionization has been declining in Canada since the mid-1980s and the labour movement has been on the defensive compared to the situation in the 1960s and 1970s. Union bargaining power has been limited by a competitive economic environment and strike activity has been historically low.

Education and Training

Commissioners identified the central issues as the extent to which education should be focused on producing generalists or specialists, how much to spend on education and training, the balance of expenditure between education and training, educational standards, and the flexibility and adaptability of the education system.

Commissioners expressed frustration with the lack of relevant data on, and analysis of, education, an absence made more glaring by the substantial public and private investment in the area. What little data were available related principally to such components as expenditure per student rather than to the results produced by the educational process. The absence of suitable information was especially noteworthy at the elementary and secondary levels, making it difficult to assess concerns about declining educational quality. As a consequence, the Report concluded that "there is a need for a national body to develop achievement-testing procedures and to monitor standards of achievement across Canada" (pp. 739-40). The situation today contrasts sharply with that of 20 years ago. Measurement of student achievement has been a growth industry, especially during the 1990s (Riddell 2004). A royal commission with a similar mandate would now have much more relevant data and analysis on which to examine the quality of elementary and secondary schooling.

The Commission pointed out that at the post-secondary level, the absence of relevant data and analysis was also striking. Here the Report made a number of recommendations related to accessibility, levels of funding, quality of post-secondary education, and the flexibility and adaptability of the system. Indeed, the Report not only suggested reforms, it recommended that federal-provincial negotiation begin immediately. This is an interesting suggestion because the mid-1980s was a relatively tranquil time compared to the tumultuous period that followed.

Some of the detailed recommendations relating to federal-provincial funding arrangements no longer apply because of subsequent changes in funding arrangements between the levels of government. However, others — such as the introduction of an income-contingent loans program, deregulation of tuition fees, and provision of more funding directly to students — have become familiar components of the debate over the future of post-secondary education.

Income Security

Chapter 19 begins with a lengthy discussion of the objectives of the income security system and program design considerations. It then reviews key features of the system that was in place. This review leads to the conclusion that the system is "badly flawed" (p. 783). It is criticized for being ineffective, too complex, and inequitable, as well as creating work disincentives and possibly not being financially sustainable. The Report lays out a number of desirable piecemeal changes, as well as a comprehensive reform package. The latter, called the Universal Income Security Program consists of a guaranteed annual income with a relatively low base, a low tax-back rate, and a top-up to the basic guarantee for those who cannot be expected to work. Such a system would replace the majority of existing transfer programs and personal and family tax credits and exemptions.

In proposing a major reform of income security, commissioners were aware both of the problems with the existing system and also of the need to anticipate substantial adjustments from changes proposed elsewhere in the Report. "The changes commissioners propose elsewhere will call for major and sometimes difficult adjustments, and the effects of these will be felt by millions of Canadians" (p. 773).

Conclusion

I conclude with brief observations on the Commission's impact on subsequent developments, a task that other papers in this volume address more fully. This is a highly speculative exercise because we do not know what would have occurred in the absence of the Commission.

In some cases, such as UI reform, one can point to a fairly direct line from the Report's diagnosis and recommendations to those ultimately implemented in the 1990s. Following the Commission's recommendations, the federal government established the Commission of Inquiry on Unemployment Insurance (the Forget Commission) which reported in 1986. Although differing in detail from the Macdonald Commission, the Forget Commission also suggested focusing UI on insurance objectives and introducing a separate comprehensive income security program. A similar direction of reform was also recommended at the provincial level in the 1987 Report of the Newfoundland Royal Commission on Employment and Unemployment. Although these proposed changes had much in common, large budget deficits during the 1980s made it difficult to introduce the comprehensive program of income support that the Forget and Macdonald commissions regarded as a necessary concomitant of UI reform.

Although UI reform was not implemented until a decade later, many of the concerns raised about the consequences of Canada's UI program continued to be investigated. Subsequent research, such as that by Green and Riddell (1997) and Baker and Rea (1998) on the tailoring of employment periods to the entrance requirement and by Corak (1993) on the repeat use of UI, also contributed to the momentum for changes to Canada's UI program. It is difficult to determine whether the Report's contribution to UI reform consisted mainly of documenting problems with the existing system and proposing suitable changes, or raising concerns that were subsequently validated. If subsequent research had not found evidence of tailoring behaviour and substantial repeat use, the momentum for change might have been lost.

In other cases, commissioners' recommendations were followed to a considerable degree, although it is difficult to determine to what extent this happened because of the Report. For example, most Canadian jurisdictions did exercise caution in raising minimum wages during the following decade. Similarly, there was a substantial increase in the measurement of student achievement at both the elementary and secondary levels, including the introduction of the School Achievement Indicators Program, which provides data that are comparable across provinces and over time, as recommended by commissioners. As well, many features of the proposed TAAP were incorporated as active employment policies in the employment insurance reforms introduced in the 1990s. Another example is income security where, although Canada did not adopt a guaranteed income program, the Commission's general approach to supplementing incomes of the working poor exerted considerable impact on subsequent developments, such as the National Child Benefit.[1]

In other instances, the Report's recommendations were not followed. One example is that of equal pay for work of equal value. Despite the Report's expressed caution regarding this initiative, the momentum for pay equity continued to build in Canada, culminating in its introduction in the private sector in Ontario during the 1990s. An interesting feature of this case is that the Ontario experience indicates that the Report's expressed caution was appropriate.

In summary, the Commission's examination of labour markets and social programs was detailed and wide-ranging. Among many recommendations, the most dramatic were the proposed reforms to UI, adjustment assistance and income security. Subsequent policy changes in these areas were not as sweeping as those proposed by the Commission. Still, the analysis and recommendations in these and other areas appeared to exert considerable influence on subsequent policy developments.

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[1] See Jonathan Kesselman's paper in this volume for further discussion.

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Labour Markets and Social Policy:
Impacts of the Macdonald Commission Report

Jonathan R. Kesselman

The Macdonald Commission Report has exerted significant influence over subsequent Canadian labour and social policy developments. I will focus on two principal areas: unemployment insurance reform and a guaranteed income plan. Both of those Commission proposals have affected later policies — notably, the Employment Insurance program of 1996, the Child Tax Benefit of 1993, and the National Child Benefit System of 1998. Each of these areas warrants scrutiny for the original package of proposals and what it has spawned. I believe that we can derive useful insights for the course of future policy from past experience.

Unemployment/Employment Insurance

First I consider the Commission's proposals for reform of the Unemployment Insurance program, or UI, as it was called at the time.[1] The Commission's recommendations were part of a long series of deliberations on how to improve UI. The 1971 *Unemployment Insurance Act* had dramatically enlarged the existing program and created many unanticipated effects on labour markets, particular industries, regional economies, and the macro economy. Between 1971 and 1972, UI benefit payments more than tripled, in spite of a small drop in unemployment, and within another five years they doubled. Numerous legislative changes were made to UI in the 1970s and the 1980s prior to the Commission Report; their general bent was to curb abuses, restrict benefits, and reduce the federal government's contribution to program costs.[2] The Report stated:

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* I thank Catherine Cheng for excellent research assistance and David Laidler, Bill Robson and John Richards for helpful comments.

[1] For the Commission's primary background studies on the UI program, see Cousineau (1985) and Kesselman (1985).

> Although commissioners place primary emphasis on the insurance objective, the benefit and financing provisions of the UI system should also facilitate, rather than retard, labour-market adjustment; they should contribute to economic stability and be designed to promote equity and economic efficiency within the Canadian economy (Volume II, pp. 602-603).

The Report further stated:

> [It is the] Commission's view that the UI program has become too large relative to other labour market programs, and that the employment opportunities for Canadians would be improved by switching some funds from UI support to programs organized to facilitate adjustment to technological and economic change (p. 612).

The Commission's specific recommendations for reform on the benefit side of the program included:

- Reducing the benefit rate to 50 percent of insured earnings (from the existing 60-percent rate);
- Raising the entrance requirement to 15-to-20 weeks of insured work over the preceding year (from the existing 10-to-14 week requirement);
- Tightening the linkage between the period of insured work and the maximum benefit period, such as "a ratio of two or

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[2] Note that the Commission's analysis of UI reform was followed by those of the Commission of Inquiry on UI (the Forget Commission 1986), the Newfoundland Royal Commission on Employment and Unemployment (the House Commission 1986), and the Standing Committee of the House of Commons on Labour, Employment and Immigration (the Hawkes Report 1987).

three weeks of work to qualify for one week of benefits" (p. 611), and
- Eliminating the program's extended benefit periods based on regional unemployment rates.

The last three features were seen as important in reducing the UI program's support for seasonally unstable industries and employment.

On the financing side of the UI program, the Commission offered two recommendations. It urged that the macro-stabilizing properties of the program, which had been diminished between 1976 and 1980 with reduced federal contributions, be enhanced through greater federal finance of incremental UI costs caused by cyclical fluctuations. It also stressed the desirability of experience-rating UI premiums, which base the premium rate charged to each employer on its own rate of lay-offs generating UI claims. The economic benefits of experience rating had been confirmed in the U.S. state UI programs — giving strong incentives for individual employers to stabilize their employment and reduce layoff rates, attenuating inefficient cross-industry taxes and subsidies implicit in uniform premium rates, and reducing the aggregate unemployment rate, as well as the rate consistent with stable inflation.[3]

All of the numerous changes to the UI program since the 1971 *Act* have been relatively piecemeal. Although their cumulative impact was significant, none of the reforms accepted the need for a sharp change in the program's nature. None sought to restore the program's pre-1972 social insurance basis, to shift key redistributive components into other programs, nor to introduce experience rating to employer premiums. The 1996 reforms that renamed the program Employment Insurance did pursue the tack of some earlier initiatives, such as higher entry qualifications for UI benefit repeaters, introduced in 1978, to tie benefit entitlements more closely to claimants' earnings and claims histories. Among its major provisions was an "intensity rule" that reduced the benefit rate for frequent claimants by up to 5 percentage points from the then-standard 55 percent of average insured earnings. Another provision sharply stiffened the tax-based claw-back of UI benefits from earners with above-average incomes. A third provision shifted the threshold for claiming benefits from weeks of insured earnings to hours of insured earnings.[4]

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[3] Experience rating is a perennial favourite of economists for UI program finance; see, for example, Kesselman (1983, chapter 9) and Canada Department of Finance (1998, chapter 8). For recent empirical assessments of the labour-market effects of UI experience rating, see Beauséjour et al. (1998) and Anderson and Meyer (2000).

The political difficulty of reforming the EI program has been demonstrated by the partial reversals of even the relatively modest 1996 reforms. This retreat has been widely attributed to the fact that the Liberal government suffered severe losses in the 1997 election in the Atlantic provinces as a result of the 1996 program reforms. In 2001, the government eliminated the intensity rule and backtracked on the EI benefit claw-back for higher earners. More recently, the higher entrance threshold for part-time workers based on hours of insured earnings has been attacked and may prove vulnerable.

Moreover, instead of following the Commission's recommendation for increasing federal contributions to UI during recessionary periods, the government eliminated all contributions to the program by 1990. And there is no evidence that Ottawa has seriously considered proposals made by the Commission and others for experience-rating the program's financing. The intensity rule and benefit claw-back of 1996 were sold as "worker-side experience rating" (Nakamura and Diewert 2000), though they proved as politically unpalatable as employer-side experience rating of premiums. Indeed, since the mid-1990s, Ottawa's most notable attitude toward EI is that the program is a handy, covert source of net funds for other governmental purposes.

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[4] Other significant changes in the 1996 reforms included a family supplement for low-income claimants with children, a reduced maximum benefit period from 50 to 45 weeks, a divisor rule to encourage work beyond the minimum entrance requirement, and a reduction in the maximum insurable earnings. See Canada Employment Insurance Commission (2001, Annex 1) for details on the 1996 UI reforms.

There is no shortage of economically sound proposals for improving the labour market characteristics of EI or for creating a more effective combination of jobless benefits for temporary job losses, active labour force measures for workers with more deep-seated barriers, and income maintenance for those with limited employability. But there are serious, seemingly intractable, political problems in implementing those proposals. The economy is an organic entity and has adapted to the more than three decades of UI benefit provisions since the 1971 *Act*, with many hiring and employment practices, as well as lifestyles, geared to optimizing the collection of these benefits. The body politic is a similarly organic entity that does all in its powers to resist attempts to reduce the accessibility and generosity of benefits.

In an unusually candid observation for an official source, a chronicler of the UI program at Human Resource and Skills Development Canada offered the following insights:

> [P]roposals to move the income supplementation elements to new programs have foundered on the political reality that one has to convince people that the new system will be no less beneficial than the UI program. So far, critics calling for comprehensive restructuring with a stripped-down UI program based on social insurance principles and with income supplementation initiatives going elsewhere have not been able to sell their ideas to the public or the federal government. The leap from public-policy theory to program reality has claimed every call for basic change. The only changes that have been adopted have been those which work within the existing framework of a UI program that has both income replacement and income supplementation or redistribution elements (HRSDC Undated).

Hence, fundamental reform of EI is much more a challenge for political design than economic design. It is worth considering the methods that have been used in various policy contexts to smooth the acceptance and implementation of major reforms or at least to blunt the opposition. To mention a few:

- Grandfathering of current beneficiaries: This would likely not be deemed equitable or acceptable in the EI context, particularly if it applied to their future benefit claims.
- Gradual or phased implementation: This approach gives opponents of change time to marshal effective political resistance, unless offsetting benefits are added.
- Delegate authority and financing to a different governmental authority: This may offer potential in regionally concentrated industries, such as fishing — because of the significance of EI fishing benefits; relevant provincial governments might be better-placed to implement effective reforms if they are willing to grasp the nettle.
- Divide-and-conquer: Outside of the regionally concentrated fishing industry, major net beneficiaries of EI include dispersed industries, such as construction; experience-rating or industry-rating of premiums could gain support from the more stable industries; by insulating the politically potent fishing sector, more basic changes might then be attainable.
- Two steps forward, one step back: In essence, this was the result of the 1996 UI/EI reforms and the 2001 retreat. This approach consumed disproportionate political capital and is unlikely to be consciously repeated in this policy arena.

No obvious winners emerge among the cited strategies for reforming the EI program. Fundamental policy reform will likely have to await a government willing to spend the requisite political capital and to persist until the resultant economic benefits make the reforms sustainable. Moreover, stiffening the social insurance basis of EI presumes that there exist feasible and attractive alternative programs for taking up the income maintenance function. The Commission pinned its hopes for that purpose on a guaranteed income program, to which I now turn.

Child Poverty and Guaranteed Incomes

The Universal Income Security Program (UISP) was the Commission's other major recommendation for reforming income security.

In essence, the UISP was a guaranteed income program that would have replaced other plans, such as the Guaranteed Income Supplement, Family Allowances, the refundable child tax credit, child and marital tax exemptions, federal social housing programs, federal transfers to the provinces for social assistance, and the income support functions of UI. UISP payments were to be made on an income-tested basis, with a tax-back rate of 20 percent applied to all income, in addition to the normal personal income tax rates. The Report stated that "the UISP seems to commissioners to be the essential building block for social security programs in the twenty-first century" (p. 826).

The Commission offered two illustrative versions of UISP benefit levels; its more generous version had a guaranteed income of $3,825 per adult (and for the first child in a single-parent family) and $765 per child, both annual rates in 1985 dollars. Adjusted to 2004 dollars, this guarantee would be $15,270 for a family of two adults and two children or $12,720 for a single parent with one child. Note that the proposal would have reduced provincial social assistance benefits, though not eliminated them; and it also recommended that the benefit phase-out rates on remaining social assistance benefits be reduced to encourage workforce entry. As a first stage in implementing the UISP, the Commission recommended collapsing the Family Allowance, the refundable child tax credit, and the child tax exemption into a single payment. That payment would be delivered either as a lump-sum transfer like the Family Allowance, or as a refundable tax credit, with a suggested benefit level of $1,000 per child and phase-out at 5 percent of family income above $26,000.[5]

The UISP proposal followed the 1960s and 1970s tradition of thinking about guaranteed income and negative income tax programs. The Canadian income security review of the mid-1970s proposed a form of guaranteed income, though this avenue was foreclosed by a growing federal budgetary deficit. However, by the time of the Commission's work, the guaranteed income concept had become tarnished by concerns over its impact on effective marginal tax rates (EMTRs) and associated costs in terms of efficiency and incentives. It was surprising that the Commission opted for a plan of this kind, given that only one of its background studies had considered the approach at all and recommended that it not be pursued.[6] Like almost all guaranteed income proposals, the UISP was beset with problems of high total EMTRs when combining the benefit phase-out with the rates of personal taxation (Kesselman 1986). In its more generous benefit version, the UISP would have pushed EMTRs to about 65 percent for family incomes between $55,000 and $75,000 (in current dollars); for most families at lower taxable incomes, the EMTR would have approached 50 percent. Even the less generous benefit version of the UISP would have sharply raised EMTRs for families with lower incomes.

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[5] It is curious that the Commission's suggested per-child benefit of $1,000 in its transitional proposal was more than the $765 per-child amount in its full-blown higher-benefit UISP variant.

The UISP proposal also would have entailed a large redistribution of incomes, raising questions about its political feasibility. The more generous UISP variant would have reduced disposable income by nearly $5,000 for families with $50,000 — a 10 percent cut in net incomes, unprecedented in the history of Canadian tax and benefit measures. The gains at lower earnings levels would have been similarly unprecedented in size; the Commission cited gains of $5,000-to-$7,000 among families with earned incomes in the $8,000-to-$10,000 range, so long as they did not bear any losses from reduced social assistance payments or terminated housing benefits.

What has been the impact of the Commission's recommendations on the reform of Canadian income security? Despite the fact that Canada has not pursued a guaranteed income along the lines of the UISP, the Commission's general approach has nevertheless had a significant impact on subsequent policy developments.

First, in 1993 the Child Tax Benefit (CTB) replaced Family Allowances (which were subject to a claw-back at higher incomes beginning in 1989), the non-refundable child tax credits (which

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6 See the discussion in Kesselman (1985, pp. 289-90), which recommended confining use of the guaranteed income approach to groups with limited employability.

replaced the child tax exemptions in 1987), and the refundable child tax credits. Kesselman (1993) provides a strong critique. The CTB was remarkably similar to the Commission's earlier proposal for amalgamating all child benefits into a single program. Even the income threshold of $25,900 for phasing out the CTB was close to the $26,000 figure suggested by the Commission, although lower in real terms, and the 5 percent phase-out rate that the Commission recommended was applied in the CTB for families with two or more children. The CTB also offered an earnings-related benefit supplement for the working poor, though not to families on welfare, which reduced the disincentive to leave welfare for work, an objective urged by the Commission.[7]

Second, beginning in 1998, the National Child Benefit (NCB) System subsumed the CTB and replaced its earnings-related benefit with a substantial cash supplement for lower- income households with children. Under agreements with the federal government, most provincial governments reduced their social assistance benefit rates for children by amounts equivalent to the NCB supplement. Again, this program pursued a Commission goal of reducing the disincentives for welfare beneficiaries to seek or return to work. These changes also reduced the break-even income levels for welfare beneficiaries, though the provinces have not reduced phase-out rates for their own benefits. The reinvestment of provincial savings from reduced social assistance cash benefits into in-kind benefits for the working poor and welfare beneficiaries promoted the lowering of the welfare wall, but the benefit phase-outs further aggravated disincentives for the working poor.

Despite the visible gains from the NCB initiative, the program also mirrored the hidden deficiencies of the Commission's UISP proposal. That is, the NCB supplement phase-out sharply raised the effective marginal tax rates faced by many working poor and near-poor families. The NCB lowered the welfare wall, while simultaneously raising the success wall, keeping the working poor and near-poor from advancing to better earnings.[8] For example, with one, two, and three or more children, the NCB supplement phase-out now adds 12, 23, and 33 percentage points, respectively, to the EMTRs of the parents. Common total EMTRs for affected families, including personal tax, payroll tax, and provincial benefit phase-outs, are 50 percent and can rise to 80 percent or more.[9] In 2004, these phase-outs applied to incomes from about $23,000 to $35,000 for families with one or two children and intersect the upper part of the poverty range for families living in large urban areas.

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[7] This strategy of reducing the welfare wall by increasing benefits for the working poor was further promoted after the Commission's Report in analyses by the Ontario Social Assistance Review Committee (1988), the 1990s Social Security Review, and researchers at the Caledon Institute of Social Policy. Kesselman (1994) advanced an early critique of this strategy — that disincentives were simply being shifted to higher up the income scale.

Non-economists often fail to appreciate not only the economic efficiency concept, but also the magnitude of efficiency losses imposed by programs like the NCB supplement phase-out.[10] For example, raising a household's EMTR by half increases the efficiency losses by 125 percent. This result follows from the standard economic finding that distortions rise with the square of the tax rate. Some observers have suggested that families are not aware of the phase-out rates or that their responses are insignificant.[11] However, that view is at odds with the economic evidence from varied empirical studies of household behaviour. When individuals lose more than half of their incremental earnings in tax payments and social benefits, they respond in diverse ways, such as reduced over-time and moonlighting and increased tax evasion and benefit fraud.

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[8] If society places a higher value on getting individuals off welfare and back into the labour force (the so-called extensive margin of labour supply) than on reductions in work hours by individuals already in the labour force (the intensive margin), these higher efficiency costs may be acceptable. See Saez (2002) for an analogous assessment of the U.S. Earned Income Tax Credit, which operates similarly to the former Working Income Supplement component of the Child Tax Benefit.

[9] See some of the numerical examples computed for various provinces and circumstances by Poschmann and Richards (2000); at the time of that study the total EMTR rose above 90 percent for some beneficiaries in Saskatchewan, but this has been reduced to 80 percent by changes in the provincial supplementary program.

[10] Inefficiencies arise when individual behaviour is distorted so that well-being is depressed below the level that would arise with a non-distorting lump-sum transfer or tax (where the EMTR is zero, by definition). For example, the income tax causes skilled workers to do more housework themselves and hire less household help, resulting in less skilled labour supplied to the market and less employment opportunity for unskilled workers.

A series of budgets have shown the NCB to be among the federal government's most favoured programs with successive increases in benefit levels. The 2003 budget contained measures to further boost benefits, raising the program cost to $10 billion in fiscal 2007/2008. Some NCB advocates are urging still greater expansion of the program, with maximum annual benefits as high as $4,000 per child. The implied effects on EMTRs, disincentives, and inefficiencies are clearly worrisome. Advocates may succeed in their goal of taking the children off welfare, but they will have put them on a program with a different name, while erecting a success wall for their low- or moderate-earning parents.

Policymakers dealing with child well-being and development also should be cautious about attributing causality to the correlation between low family incomes and poor results for the children. The research literature finds that part of this correlation reflects heterogeneity of family characteristics; unobserved characteristics of parents that lead to low earnings may also lead to adverse conditions for parenting. Recent analysts have concluded:

> Our empirical tests provide support for the claim that the true effect of income on these [child cognitive] outcomes may indeed be positive, but that it is also likely to be smaller than the conventional estimates. Overall, our findings are consistent with those of others who have sounded a cautionary note about using enhanced cash transfers as a principal mechanism for improving

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[11] For example, Battle (1999) acknowledges the "marginal tax rate dilemma" (p. 1254), yet generally dismisses "the alleged work disincentive effects of high marginal tax rates" (p. 1242), based in part on the difficulty of calculating the implicit tax rates of the benefit phase-outs and the long time lags between income changes and benefit changes.

> cognitive outcomes among low-income children. Alternative strategies, such as early childhood education programs directed toward populations at risk of developmental disadvantage, may provide a better use of public funds (Dooley and Stewart 2004, p. 915).

The Commission's UISP implicitly assumed that low incomes alone were the critical barrier for success of children; it ignored the more salient health, familial and developmental barriers faced by particular children, more common at, but not restricted to, low incomes.

Rather than allowing the NCB System to grow, an alternative approach would appear better for combating the worst consequences of child poverty (Kesselman 1994, Sayeed 1999). If part of the NCB funds were diverted to in-kind services and supports for the 5 percent-to-10 percent of children who are most vulnerable, this could have a much larger long-run impact on their lifetime prospects. Examples include expanded pre-natal counseling and nutrition programs, better child protection, improved student counseling and special education, recreation programs, early childhood learning, child disability supports, and services for troubled youth. These services can be targeted by need rather than by family income, and they can also be targeted on those locales with the greatest needs.[12]

Conclusion

In summary, the Commission's Report has exerted significant influence over subsequent labour and social policies, for better or worse. The EI program still has many deficiencies in terms of labour market distortions and disincentives resulting from both benefit and financing provisions. Still, subsequent experience has demonstrated that these deficiencies are not readily amenable to simple economic or technical solutions; any successful strategy for reform must take the political dimension equally seriously in creating effective changes. Similarly, the NCB, which the Commission's UISP proposal spawned, shares in the deficiencies of relying too heavily on a guaranteed income approach. Not only does this strategy create high effective tax rates on individuals, with associated distortions and efficiency costs, it also consumes resources that would be better directed to the needs of the most vulnerable children and youth. Both of these areas of public concern are ripe for further analysis and policy formulation in the tradition of the Commission's work.

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[12] Initiatives of these kinds will require cooperative agreements among federal, provincial, municipal, and school authorities. Such programs might be optimized by a return to a form of cost-shared grants, similar to those of the former Canada Assistance Plan, rather than block grants.

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Labour Markets and Social Policy:
A Qualified Agenda for the Future

John Richards

On the ideologically charged subject of how best the non-poor can help the poor, the Macdonald commissioners followed in the footsteps of those advocating a guaranteed income, or negative income tax. They labeled their version a Universal Income Security Program (Volume II, p. 19). The rationale for such programs is essentially twofold:

- The employment argument: A guaranteed income may increase the incentive to work by lowering the claw-back rate on incremental earned income among the poor, who would otherwise receive provincial social assistance (welfare). The claw-back rates of social assistance programs range from 75 percent-to-100 percent. Guaranteed income programs have been designed with claw-back rates of typically about 50 percent.

- The entitlement argument: When social workers assess the eligibility for income assistance, based on the applicants' handicaps, potential employability, and financial needs, and when income provided is conditional on the applicant's conforming to discretionary requirements concerning training or work, conflicts between social worker and client are frequent. Instead, say guaranteed income advocates, a minimum level of income should be a right of citizenship — the level to be a function of need, defined usually by number of family dependents. By eliminating much of the demand for discretionary pro-

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* I thank Jon Kesselman, David Laidler and Bill Robson for comments on earlier drafts.

grams, a rules-based income transfer could eliminate most such conflicts and enhance the dignity of the poor.

The Commission's Rationale For A Guaranteed Income

The following passage incorporates both arguments. The commissioners concluded that a guaranteed income could simultaneously eliminate "demeaning procedures" and incorporate "reasonable incentives" to work:

> Income-security programs should impose no unnecessary stigma or harassment on beneficiaries or potential beneficiaries. In general, social insurance, universal benefit- or income-tax-related schemes create the least stigma. [Income transfer] programs are also likely to be more acceptable if establishing eligibility is simple and requires little probing into the personal lives of applicants. In the past, demeaning procedures have been imposed on applicants in response to taxpayers' concerns about work effort and budgetary economy. It therefore bears repeating that if reasonable incentives can be built directly into the benefit structures of appropriate programs, there should be no need to retain such expensive and inappropriate "safeguard" features (p. 777).

To use the commissioners' words, governments are responsible for "the sharing of our resources so as to provide an adequate income in relation to community standards" (p. 773).

In practice, this "sharing" is a somewhat arbitrary exercise, wherein provincial cabinets and senior officials determine "an adequate income in relation to community standards" in an exercise motivated by a combination of compassion, budgetary priorities, assessment of the public willingness-to-pay, and debates over alternative strategies to help the poor.

In his contribution to this volume, Jon Kesselman discusses extensively the Achilles heel of the employment argument. If a guaranteed income program is to replace discretionary transfer programs, such as provincial social assistance, the "adequate income" for those without earnings will presumably approximate present welfare benefit levels. If, in the interest of providing reasonable incentives to earn income, the claw-back rate is set substantially below that of social assistance, the beneficiaries will include many modest-income families not formerly eligible for welfare benefits, but subject to positive taxes on earnings. To contain program cost, guaranteed income programs typically impose claw-back rates on these near-poor families that, combined with positive tax rates, erect punitively high disincentives to earn income. The effective tax rate — the sum of claw-back rates plus tax rates — often equals or exceeds the claw-back rate of traditional social assistance (Poschmann and Richards 2000). Most guaranteed income supporters minimize the import of these offsetting employment effects (Moffitt 2004)

The commissioners' arguments did not directly change social policy programming, but they help us to understand the reasoning of those who did. In Ottawa, officials who subscribed to the case for a rules-based transfer incrementally constructed the National Child Benefit System (NCBS).[1] At the provincial level, many politicians and officials accepted the criticism that social workers' exercise of discretion was giving rise to expensive and inappropriate safeguard features. In general, provinces relaxed welfare eligibility in the decade following publication of the Macdonald Report. The result was that the economic boom of the late 1980s induced only a minor decline in the proportion of Canadians in receipt of provincial social assistance. (See the data for Canada in Figure 1.) Once the early 1990s recession arrived, that proportion rose precipitously.[2]

Faced with a ratcheting up in Canadians' reliance on social assistance, most provincial officials concluded by the mid-1990s that treating social assistance almost like an entitlement had been a mistake: more conditionality was essential both to contain pro-

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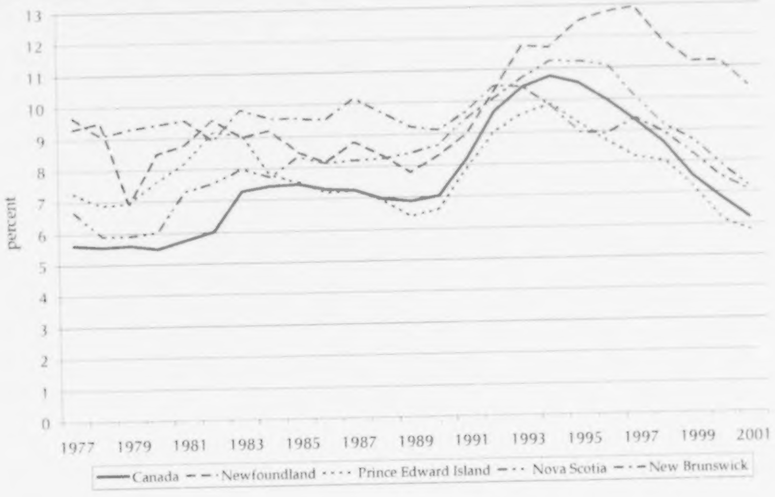
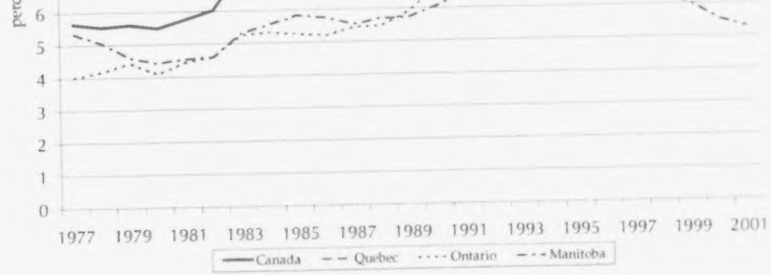
[1] While the NCBS was formally announced in 1997, elements were in place long before.

[2] The proportion of the population in receipt of provincial social assistance rose from 7 percent in 1990 to nearly 11 percent at the peak in 1994. The most dramatic rise occurred in Ontario: from below 6 percent of the provincial population in 1989 to nearly 13 percent in 1994.

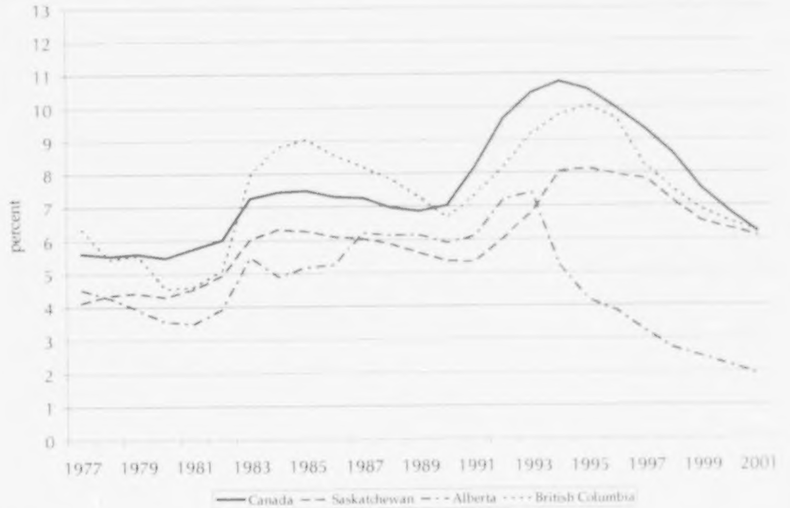
Figure 1: *Social Assistance Beneficiaries, 1977-2001, Canada and Atlantic Provinces (percent of relevant jurisdiction's population)*



Social Assistance Beneficiaries, 1977-2001, Canada and Central Provinces (percent of relevant jurisdiction's population)



Social Assistance Beneficiaries, 1977-2001, Canada and Western Provinces (percent of relevant jurisdiction's population)



Source: Author's calculations from data in Canada (2004a)

gram costs and to curtail growth of a culture of welfare dependency among a sizeable minority of the population. Social assistance became a high-profile partisan issue in the 1995 Ontario election, but in all provinces, whether the governing party changed or welfare policy became politically contentious, eligibility rules were tightened. By 2001, the latest year documented in Figure 1, the percent of Canadians receiving provincial welfare benefits had fallen to 6 percent, the lowest ratio since 1982. In Alberta, the province that changed direction most dramatically during the 1990s, the proportion receiving social assistance was below 2 percent by 2001. At the other extreme, the share of Newfoundlanders receiving social assistance remained above 10 percent.

Admittedly, there is a problem in interpreting the data of Figure 1. The proximate causes of the ratcheting up in the early 1980s and 1990s were the economic recessions of those years, and some portion of the post-1994 decline is due to restored economic prosperity. There is ample evidence, however, that changes in provincial policy mattered a great deal (Boessenkool 1997, Richards 1998).

The Picture Gets Bigger

The Macdonald Commission reported in the mid-1980s, at a time when poverty researchers were only beginning to analyze longitudinal data that followed changes among large samples of people over long periods of time, enabling researchers to draw inter-generational conclusions. It is unfair to fault commissioners for ignoring such results; they were not available. Two decades later, it is important to be cognizant of them.

Many factors — including quality of investment by parents, neighbourhood effects, quality of public schools and incidence of disease or accidents — determine whether a child grows up poor. These longitudinal studies have provided solid evidence on the importance of long-term effects arising from decisions made by families about education, divorce and change of location, as well as from decisions made by governments that impinge on quality of schools and neighbourhoods. It would be foolish to imply that longitudinal studies afford certainty; they do not. But at least the disagreements are now better grounded in evidence.

To give an indication of the results such studies have generated, here is my summary of longitudinal studies bearing on one question: what determines whether children graduate from high school?[3] This is a critically important matter. In modern industrial economies, earnings in adult years are much more closely linked to formal education levels than in early decades of the 20th century. Low education levels among children are a powerful predictor of adult poverty. For children born into poor families, successful graduation from high school is perhaps the best indicator as to whether they will escape their parents' fate.

Parental education matters. In explaining the probability that a child will graduate, nearly all studies conclude that parental education is significantly correlated with children's success. Given the importance of parental education in explaining the outcomes, communities with low average education levels are unlikely to reach average education levels in one generation. A qualification: parental education and family income are tightly correlated. As a result, it is hard to separate the independent impact of education and income on children's education success.

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[3] This summary is lightly documented. In constructing it, I have drawn heavily from Haveman and Wolfe (1995) and Jargowsky (1996).

Long-term parental reliance on welfare lowers the probability of high school graduation. Female-headed, single-parent families with long-term reliance on social assistance constitute a large fraction of the caseload in all 50 U.S. states and 10 Canadian provinces. The loss of parental attention when a poor parent works may lower children's education performance, but this is typically offset by the positive role model effect of a working parent. The implication is that a dollar of earned income will have a greater effect on reducing inter-generational poverty than a dollar of transfer income.

Very poor neighbourhoods have a negative effect on children's educational success. Very poor neighbourhoods often harbour complex syndromes abetting inter-generational poverty: poor quality local services (poor quality schools in particular), low employment rates among men in their prime earning years (hence, a low ratio of working fathers to act as role models), high rates of female-headed, single-parent families (with high rates of reliance on social assistance), limited interaction with the mainstream society due to ethnic, linguistic or racial ghettoization. The effect of living in a very poor neighbourhood on children's outcomes is more severe than individual family characteristics would predict. There are exceptions, however, such as neighbourhoods of Asian immigrants where parents are poor, but families are intact and education prospects for children are above average.

Stressful events, such as parental separations and changes in family location, have negative effects on children's education success. This conclusion is well established. However, the counterfactual is hard to specify: what would have happened to the children if the parental separations or changes in location had not taken place? Unhappy parents are not conducive to children's education success.

The Evolution Toward Workfare in the U.S. and Britain

The cumulative impact of studies lying behind the above summary has been, in the United States and Britain, to reorient anti-poverty programs over the past two decades. In both countries, recent programs have imposed stricter work requirements for those deemed employable. And this category has been defined to include single-parent mothers with young children. A prominent analyst of U.S. poverty is Lawrence Mead. In an essay written for a British audience in the early months of the Labour government elected in 1997, he summarized his policy conclusions:

> [F]amily breakdown has undercut functioning even though [U.S.] society has become much more fair [than in an age before the 1960s' civil rights programs]. The main task of social policy is no longer to reform society but to restore the authority of parents and other mentors who shape citizens. Government has no easy way to do that, but the best single thing it can do is to restore order in the inner city. Above all, it can require that poor parents work, because employment failures are the greatest cause of family failures (Mead 1997, p. 15).

Mead is among the more conservative of major U.S. policy analysts, although well within the range of mainstream thinking. He played a role in the design of several major Congressional initiatives, the most important of which is the 1996 *Personal Responsibility and Work Opportunity Reconciliation Act*. This legislation terminated Aid to Families with Dependent Children (AFDC), the framework for federal contributions to the funding of state-administered social assistance since Roosevelt's New Deal. In its place, Congress launched a new transfer to states, Temporary Assistance to Needy Families (TANF). TANF gave states more discretion in the design of social assistance programs, but also imposed stricter work requirements and cumulative time limits for receipt of benefits (Mead 2002). Britain's New Deal, introduced in 1998 by the newly elected Labour government, incorporates a similar emphasis on employment as a precondition for training, childcare, and other forms of assistance (Walker and Wiseman 2002). Governments of both countries fund large programs that supplement earnings among low-income families with children. The Earned Income Tax Credit is now worth as much as US$2 per hour among eligible parents. Britain's Working Tax Credit has a similar level of generosity.

The emphasis on time limits and inducements to employment reduced the U.S. welfare caseload by 60 percent between 1994 and 2001 (Cancian et al. 2003). An obvious question is: what has been the impact on incomes and the incidence of poverty?

In a survey conducted by the Institute for Research on Poverty at the University of Wisconsin – Madison, Maria Cancian and colleagues (2003) reported on surveys of 8,000 welfare-receiving families in three states: New Jersey, Wisconsin, and Washington. Between the first and second years of participation in their respective state welfare-to-work programs, own earnings rose on average by about US$2,000 per family. However, claw-backs on transfer income reduced by roughly half the net increase in average family income. In all three states, poverty rates, as measured, fell by about 10 percentage points. These results are fairly typical. U.S. welfare reform has improved incomes for the majority, though it has deepened poverty among a minority. The surveys found considerable variability: among a minority of about 20 percent, earnings declined in the second year relative to the first and while poverty rates fell in the second year, the second-year poverty rates in the sample remained in the 40 percent-to-50 percent range.

It is worth noting that these programs are not in general a means to reduce government spending. The successes have required Washington to enrich the EITC, and required states to hire additional professional social workers, and to subsidize childcare and health insurance for single mothers returning to work.

Access to health insurance is an important consideration in the design of welfare-to-work programs for low-income parents. Britain and Canada enjoy an advantage over the United States because they have health insurance as a universal program. The income-contingent nature of the U.S. system (Medicaid) is a major impediment to parents with limited market skills embracing full-time employment over social assistance.

Canadian Inertia

Relative to policy debates in the United States and Britain, Canadian discussions of poverty have evolved more slowly over the last two decades. Now, as at the time of the Macdonald Commission, there is a good deal of support, particularly in Ottawa, for rules-based income transfers intended to reduce the demeaning procedures and stigma of discretionary programming. A reluctance to acknowledge the Achilles heel of punitive effective tax rates on the near-poor remains as prevalent in contemporary Ottawa as among the Macdonald commissioners.[4]

The motivation of many U.S. innovations over the last two decades has been to rejuvenate inner-city ghettos. In addition to welfare-to-work programs, United States authorities have experimented extensively to improve education outcomes among identifiable groups of poorly performing students. These experiments include bonuses to attract good teachers to inner-city schools, early childhood learning programs in poor inner-city neighbourhoods, magnet schools intended to validate minority cultures, and — what has proved most controversial — use of school vouchers enabling low-income parents to escape weak public schools.

The closest Canadian analogue, in terms of social exclusion of identifiable minorities suffering high poverty rates and low education levels, is communities of Aboriginals. Indirectly, through cash transfers to bands, the Department of Indian Affairs is financing an on-reserve welfare system with 150,000 beneficiaries. The proportion of the on-reserve population in receipt of social assistance has declined over the last decade, from above 50 percent to below 40 percent, but this remains a distressingly high ratio (Canada 2004b, p. 56). Indian Affairs is also funding a system of band-run primary and secondary schools that, overall, are performing inadequately. Federal officials invoke the failures of past paternalism to justify their present reluctance to interfere with band-run welfare or schools. While the racism implicit in early 20th-century policy immensely complicates all current discussion of Aboriginal policy, Ottawa's passivity is hard to defend.[5]

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[4] If benefits to the poor are to remain intact, the only means to lower the impact of claw-backs on the near-poor is to lower the claw-back rate and enable middle-income families with children to enjoy more substantial benefits. To do this is expensive in terms of foregone tax revenue and it increases the effective tax rate across middle-income families.

Education levels — and resulting economic conditions — are considerably better among off- than among on-reserve Aboriginals, but nowhere are Aboriginal education levels similar to those among non-Aboriginals. Nearly four out of five kindergarten-to-grade 12 Aboriginal students attend schools organized by the provinces, rather than on-reserve, band-run schools.[6] We know very little about how these children are faring in provincial schools. What we do know comes largely from British Columbia, the one province to document adequately the performance of its Aboriginal students. The other provinces simply do not collect and report outcomes on Aboriginal students.

Alberta's Exceptionalism: the Cardinal Reforms

Alberta is an exception to the conclusion about inertia in Canadian anti-poverty policy. Prior to 1993, Albertans' collective reliance on social assistance was similar to that in the two other Prairie provinces (Figure 1). In 1993, a new minister of social services was appointed. Mike Cardinal is a civil servant-turned-politician, an Aboriginal, and a consistent critic of the perverse impact of welfare on Aboriginal communities. Under his direction, the province launched a workfare program that, in broad outline, resembles U.S. state programs more than those of other Canadian provinces. The core strategy underlying the Cardinal reforms was the imposition of high barriers to welfare access among those deemed employable, combined with some training support and help in work placement (Boessenkool 1997).

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[5] The recent report of the Auditor General (Canada 2004c) reiterated the failure of the Department of Indian Affairs to monitor performance of on-reserve schools.

[6] This estimate is based on the distribution between Aboriginals living on-reserve (approximately 30 percent) and off-reserve (70 percent). All off-reserve Aboriginal children and 35 percent of Aboriginal students living on-reserve attend off-reserve provincial schools.

As with the U.S. workfare programs, what has been the impact on incomes and incidence of poverty? A Statistics Canada study (Picot et al. 2001) recorded trends in the poverty rate and poverty gap across Canadian provinces during the 1990s.[7] Between 1993, the year the Cardinal reforms were implemented, and 1998, the poverty rate in Alberta and in Canada overall declined. In 1993, Alberta's rate was slightly above the Canadian average; by 1998, it equaled the national rate. Over these five years, the poverty gap remained higher in Alberta than in Canada overall. (In both Alberta and Canada overall, the gap rose over these five years, slightly faster in Alberta than elsewhere.) Increased employment among the poor was a central goal of the reforms. At the time of the 1996 census, the employment rate in poor neighbourhoods of Calgary and Edmonton was significantly higher than that in similarly poor neighbourhoods of other western Canadian cities (Richards 2001).[8]

Conclusion

Kesselman, in another chapter in this volume, concludes with an appeal to divert some fraction of National Child Benefit funding to the provision of better services for the most vulnerable of children. I agree. Policies based on rules-based transfers should play only a limited role in the case of those deemed employable. Providing services such as early childhood education, and attaching conditions to income transfers, are more effective long-term strategies.

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[7] The study used 1992 LICO values as the poverty threshold. The poverty gap refers to the difference between the relevant LICO threshold and the average income among the poor expressed as a percentage of the relevant LICO. The larger the gap, the deeper the poverty among those below the threshold.

[8] In this study, "poor neighbourhoods" were defined as census tracts having LICO-based family poverty rates above 33 percent, this being twice the national average poverty rate prevailing in Canada in 1995. In terms of Aboriginal employment in poor neighbourhoods, Alberta's advantage over cities in other western provinces was more pronounced than its advantage among non-Aboriginals.

Ideologically charged debate and uncertainty will always loom large in the making of anti-poverty policy and conclusions must be couched accordingly. With that caveat, I offer the following three-point agenda:

- Emphasize employment, even when employment is at low wages. Such a strategy requires governments willing to impose rigorous criteria on eligibility for social assistance, and qualified social workers able to apply the criteria with professional discretion. To render employment more attractive among low-income parents with few formal skills, earnings supplements make sense.
- Experiment aggressively to improve high school completion rates among identifiable groups of low-income families. Early education programs targeted to low-income families make sense.
- Reduce the punitive effective tax rates currently imposed on the near-poor. Accept the fiscal implication that middle class families with children pay less tax than comparable-income childless families.

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International Trade:
What the Macdonald Commission Said

Gilbert R. Winham

The Macdonald Commission, or the Royal Commission on the Economic Union and Development Prospects for Canada, had an immense mandate. After only three years of work, it produced a massive three-volume report in September 1985, supported by 72 volumes of research. In all this work, the "most immediate impact of the Commission was to give greater legitimacy and momentum to the argument for free trade with the U.S." (Banting 2004). In so doing, the Commission's Report was instrumental in ending the protectionist National Policy of 1879 which had effectively guided Canada's international trade policy for 100 years following its enunciation.

Adjusting to the Markets

On international trade, what the Commission said can be summed up in three themes. First, it emphasized the primacy of market principles in managing the Canadian economy. In the past, many Canadians had come to expect their government to coordinate the activities of industries to make them competitive both domestically and internationally, but the Commission argued such coordination posed the danger of "denying the genius of the market economy and inhibiting the flexibility and adaptability so evidently required to compete effectively" (Volume I, p. 51). Greater reliance on market forces for industrial and trade policy would represent a marked departure from past policy because, in the past, Canadian policy had been to "postpone, rather than facilitate adjustment" (p. 241). The Commission recommended that Canada's future policies "must be measured according to the speed with which they enable our industries to adapt to changing economic opportunities, and not according to their capacity to postpone adjustment" (p. 241). In sum: "The stimulation of competition is the key to economic growth and productivity improvement" (p. 62).

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The Commission offered its views on industrial policy, but on this subject it enunciated again its support for market principles.[1] Free trade had the potential, in the Commission's view, to create" a fundamental change in the relationship of the state to the market" (pp. 62-63).

The second theme amounted to an analysis of the global economy. The Commission spoke of the "new realities" of the international political economy, to which Canada as a trading nation would be particularly susceptible. "The state itself," said the Commission, "clearly exists in a more open international environment than it did even a half century ago" (p. 29), leading to a greater climate of uncertainty where national governments were less able to manage and control their economies than they were in the early post-war period.

In addition, there were developments that put Canada in an especially vulnerable position. One was a growing trend toward regionalism.[2]

Another was the forecast that world trade would not favour primary products in the coming decade, requiring Canada to increase its capacity to produce and export competitive manufactured products. For Canada to respond to these new realities, the Commission recommended that the domestic economy must adapt to meet international competition and that social and industrial policies be adjusted accordingly. This strategy of adaptation would present a great challenge, but it was "a challenge we have no alternative but to meet" (p. 58).

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[1] "The question of whether to opt for free trade or for protectionism is undoubtedly the key issue to be resolved in forming an industrial policy" (p. 200).

[2] "Because Canada is not a member of any preferential bloc, it is one of the few major industrial countries lacking access to a market of over 100 million people" (p. 245).

The third theme dealt with the United States. The Commission noted the growing importance of the U.S. market in Canada's trade and concluded that Canada should accept its dependence on the United States and seek to maximize security in this relationship. The Commission invoked a seminal article on the history of the Third Option Policy that argued Canada had drifted without much deliberate direction toward a "fairly steady maintenance of the status quo in our relationship with the United States" (p. 299). For the Commission this meant that Canada had overlooked the second option that would "move deliberately toward closer integration with the United States" (p. 299), and that would in turn enable Canada "to seize opportunities arising from our close ties" (p. 248).

However, there were not only opportunities in the U. S. relationship, but also problems, because that country had occasionally invoked contingency protection in the form of anti-dumping or anti-subsidy measures against important Canadian exports. Therefore, securing access to the U.S. market should be an important principle in Canada's trade policy.[3] The Commission recommended bilateral negotiations with the United States to implement a Canada-U.S. free trade agreement.

The immediate objectives of this policy were to increase market access to the United States, to secure that access, and to increase the competitiveness of Canada's domestic economy (pp. 323-25). The first objective took into account that although average tariff protection in the United States was considerably lower than that in Canada, there were still areas where U. S. protection impeded Canada's exports and where greater market access could be won. The second objective focused on U. S. contingent protection, and reflected the concern that if Canada's principal market was to be the United States, access to that market would have to be more secure than recent history had shown it to be. And the third objective reflected the conviction among the commissioners that going head-to-head with U.S. producers would prove, in the last analysis, to be Canada's greatest opportunity to enhance the productivity and performance of its economy.

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[3] "It is imperative that Canada reduce both the uncertainty of our access to U.S. markets and the adverse effects that might result from any trade-restrictive measures" (p. 324).

The Commission did not call for bilateralism exclusively, but instead argued that Canada's traditional multilateral approach should be complemented by unilateral initiatives and bilateral negotiations. It was because of the unique situation in the global economy, where Canada had a high trade dependence on the United States and lacked unimpeded access to any large market, that the bilateral route presented a more attractive option for Canada. Because of these circumstances, the Commission was pessimistic that the General Agreement on Tariffs and Trade (GATT) negotiations could ensure Canadian objectives, and it was "unconvinced that Canada should pursue the multilateral route to trade to the exclusion of opportunities which [could] be best realized bilaterally" (p. 296).

In the end, the Commission wanted a stronger and more secure Canadian economy and it claimed that securing access to the U. S. market would provide Canada with greater ability to compete internationally and potentially diversify its markets.[4] The Commission stated: "In the longer term, successful competition in a North American context will lead to a greater ability to compete abroad and to diversify our markets" (p. 71).

Preparing the Ground for Free Trade

The Report of the Macdonald Commission was a seminal event in the causal chain that led to the Canada-U.S. Free Trade Agreement (FTA). The Report was warmly received by the newly elected Conservative government of Brian Mulroney because it reflected the philosophy and broader concerns of that government. That philosophy placed an emphasis on increased reliance on market forces in the economy.

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[4] "If Canadian industry can be competitive with U.S. industry, you could almost feel quite comfortable about multilateralizing the result" (p. 248).

The Macdonald Commission's recommendation for a Canada-U. S. free trade negotiation was acted on by the Mulroney government, which saw it as a means to revitalize the private sector in Canada and as a method to reduce government intervention in the economy. However, competitiveness was not an easy sell to leaders of the business community, whose support the government needed in negotiatiations with the United States. Security of access was a safer and more politically acceptable theme and therefore it became the principal demand enunciated by the government in the FTA negotiation. However, the perception that free trade would promote economic reform and Canadian competitiveness is likely what kept the Mulroney government in the FTA negotiation, especially after it was obvious the Agreement would not require the U. S. government to change its laws to reduce contingent protectionism against Canada.

Canada was not alone in seeking a mechanism to reform its domestic economy; this movement of economic policy from the state to the market occurred in many countries, likely commencing with the move toward deregulation in the domestic economies of the United States and Britain. Although the reform in those countries was mainly internal change, the size of the U. S. and British economies ensured it would have an impact in the international economy. In smaller European countries, the need for larger markets to support domestic economic growth led their governments to promote liberal economic policies, with the result that protectionism was gradually dismantled, often on a unilateral basis.

The recession of 1981/1982 produced a crisis in many countries, and especially in the developing world. During this period the Mexican government came perilously close to default on its international payments before beginning a rejection of the policy of economic nationalism that it had pursued since the Revolution of 1910. By the mid-1980s the movement toward reform was evident in many countries in the developing world. It reached its zenith in 1991 when India, the largest GATT signatory, suffered a crisis in its external payments and responded by liberalizing its domestic and foreign economic policies.

A similar move toward market reform was launched in the European Union under the program Europe 1992, which was a plan to restructure intra-EU relations to be more consistent with market principles and increase the internal coherence and external impact of the EU itself. Market reform in the EU ensured that the movement toward deregulation was a worldwide phenomenon affecting both developed and developing countries. Deregulation was part and parcel of a profound shift in economic values worldwide.

How It Measures Up

What then is the overall evaluation of the argument of the Macdonald Commission that launched Canada into a bilateral free trade agreement with the United States? Although it often appears that the FTA was a foreign trade policy in which Canada would make changes to the structure of its bilateral relationship with a foreign country, in fact it was more about the domestic economy than foreign trade. The recommendations of the Macdonald Commission dealt more with the kind of economy that Canada would have, rather than what kind of foreign economic relations it would pursue. Unlike the North American Free Trade Agreement (NAFTA), which was a foreign policy in which Canada sought to maintain its interests against initiatives by foreign countries, the FTA was at base a domestic policy in which Canada sought especially to deregulate its economy. Of course a bilateral trade negotiation would achieve trade policy goals, such as the prospect that Canada could cover its largely bilateral trade with bilateral rules, or that Canada might receive concessions on exports to the United States of which it was not a principal supplier. But these concerns took second place to the prospects that an FTA might lead to economic reform, both through the recommendations of the Macdonald Commission and in the later actions of the Mulroney government.

The Macdonald Commission was faced with a unique set of circumstances in the Canadian situation, and it responded with a unique solution. Yet there were similar circumstances in other countries and it is instructive to view the Canadian economy in a world context. In the move toward deregulation that gripped many countries in the 1980s and 1990s, it appeared that larger countries, especially the United States and members of the EU, were able to achieve reform through their own actions, and consequently they directed those actions toward their internal markets. For smaller and especially developing countries, often with a larger ratio of trade to GDP, it was convenient to use trade policy to promote change throughout the domestic economy.

Canada is not a small trading country but, as the Macdonald Commission noted, it is historically a resource producer that has been heavily dependent on trade with large external centres. It is also a federal system, with an always difficult problem of internal negotiation. This may explain why the Macdonald Commission, when faced with the problem of economic reform and change in the domestic economy, reached for a foreign policy tool to accomplish that task. As former Australian Ambassador to the GATT Alan Oxley has said of developing countries at the Uruguay Round:

> Trade liberalization will not address all developmental problems. But of all the options available to the industrializing world to address developmental problems over the next decade, it is the one within reach that can have the most dramatic effect (Oxley 1990).

The Macdonald Commission and the Mulroney government reached for that same option in calling for a bilateral free trade agreement with the United States.

The Legacy

Were the Macdonald Commission to be re-established today, what would it find, and what would it recommend? It would find a Canadian economy that has largely thrown off the legacy of the National Policy of 1879 and the orientation to the domestic market produced by that policy. The Canadian private sector has, for the most part, adjusted to the greater competition produced by free trade and has been stimulated by the challenge of tariff-free access to the enormous and affluent North American market, now including Mexico. A commission today would find companies less reliant on government to direct the economy or to support business activity. But it would also find Canada's dependence on the U. S. market for its export trade even greater than in the 1980s. It would have to recognize that Canada has become not an international, but a regional, trader, albeit with the largest and most dynamic single economy in the world. Finally, a new commission would observe that the original commission was mistaken in its expectation that the competitiveness produced by bilateral free trade would lead to greater international competitiveness and a diversification of Canada's trade.

Assuming that a new commission were to adopt the same concerns as the Macdonald Commission, what analysis or recommendations would that commission produce today? First, there would be no change regarding the primacy of market principles in managing the Canadian economy, nor in the importance of free trade as a tool to implement those principles. The political debate over free trade was largely settled for Canada when the Liberal Government of Jean Chretien embraced NAFTA. In the 20 years since the Macdonald Commission Report, the Canadian economy has become progressively more oriented toward foreign trade, and trade in turn has sustained economic growth in Canada when other sectors of the economy were faltering. There is little likelihood that a commission representative of the Canadian people would turn its back on free trade as it is implemented today.

Second, a new commission would likely adopt the realism of the Macdonald Commission, which recognized the extent of Canada's export trade dependence on the United States, which led the commissioners to think in broad terms about how Canada should manage that dependence into the future. Similarly, realism today would lead a new commission to conclude that Canada continues to be fundamentally dependent on its southern neighbour for its export trade and that as a result, security of access is an essential concern for anyone thinking about the future of Canada's commercial policy.

Beyond North America, realism would also lead a commission to recognize that the world economy has changed enormously since the 1980s. The biggest change is the emergence of certain developing countries — China, India and Brazil — as major participants in international trade and investment. The enormous potential represented by these countries is forcing producers and governments in the developed world to rethink their economic strategies. In the case of Canada, this will require more thought and emphasis on a world-wide strategy (Dobson 2002), such as the one that is now taking shape in the Emerging Markets Strategy of the government of Prime Minister Paul Martin (Peterson 2004).

Finally, like the Macdonald Commission, a new commission would also examine Canada's concentration for trade with the United States. This is the central feature of Canada's commercial profile, and an inescapable issue for economic analysis. Canada's position is still vulnerable and the issue of security of access is still foremost, but whereas Canada's insecurity in the 1980s was caused by economically motivated U. S. actions, such as contingent protectionism, today the more troubling elements of insecurity would be caused by U. S. security-motivated measures. In this sense, the terrorist attacks in the U.S. on September 11, 2001, were a NAFTA issue for Canada because of the vulnerability to security-related border closures of the country's truck-bound trade (Goldfarb and Robson 2003).

Any new commission would likely advise Canada to diversify its export trade in order to promote economic security. This advice would be no more startling than that which any business consultant might give to a company with a highly-limited customer base. The commission would also support those who call for negotiations with the United States to make the Canada-U.S. border as seamless and regulation-free as possible and less prone to closures. However, negotiating with the United States is inherently uncertain, and if pursued to the exclusion of other initiatives, it risks putting all Canada's eggs in the same basket. This worked for the Macdonald Commission, but would it work again?

The purpose of the Macdonald Commission was not to draw Canada closer to the United States as such, but rather to achieve the benefits of the greater competitiveness in the Canadian economy that would follow from liberalizing the largest portion of Canada's foreign trade. In short, the Macdonald Commission used trade policy as an engine of growth. But if a new commission were to pursue similar objectives today, would it turn to the bilateral arena in which to situate its recommendations?

Foreign trade could continue to provide growth and stimulation for the Canadian economy, but today it is trade with countries outside North America that holds the greatest promise. For example, the economy of China grew in excess of 40 per cent in the last four years. Over this time, U. S. exports to China grew by 52 per cent, while Canada's exports to China grew by only 17 per cent (Peterson 2005). This may not be good enough. If Canada is going to meet the challenges of the next decade in the international economy, it may have to improve its performance in developing country markets where the potential for growth and the rate of change is greatest. Measured against the goals of competitiveness and security of access that were so central to the Macdonald Commission's Report, a new commission would likely conclude that most of the benefits that were available have already been taken from bilateral trade with the United States and that improving Canada's trade and investment performance with leading developing countries would better accomplish the goals today for which Canada-U. S. free trade was originally recommended.

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International Trade:
20 Years of Failed Economics and Successful Economies

Daniel Trefler

Careful what you wish for. The Macdonald Commission wanted a Free Trade Agreement with the United States and ended up with an accord that included Mexico. The Commission also wanted a set of rules for dispute-settlement and institutions for enforcing those rules that would have insulated Canada from the vagaries of U.S. trade sanctions. Instead, we got rules that both went too far (the expropriation clause) and that did not go far enough (softwood lumber). Many of the problems we have had with the North American Free Trade Agreement (NAFTA) have been in the resource and agricultural sectors. NAFTA has also had some important effects on manufacturing, some of which played out along lines foreseen by the Commission, and some of which were completely unanticipated. The impact on manufacturing is the subject of this paper.

Lost Jobs and Productivity Gains

The year 1993 was the low water mark for the Canada-U.S. Free Trade Agreement (FTA). Canadian manufacturing employment had declined by 15 percent and seemed headed for oblivion. Labour unions were arguing that our country had been betrayed.[1] Fortunately, 15 years into the FTA the picture is much less bleak.

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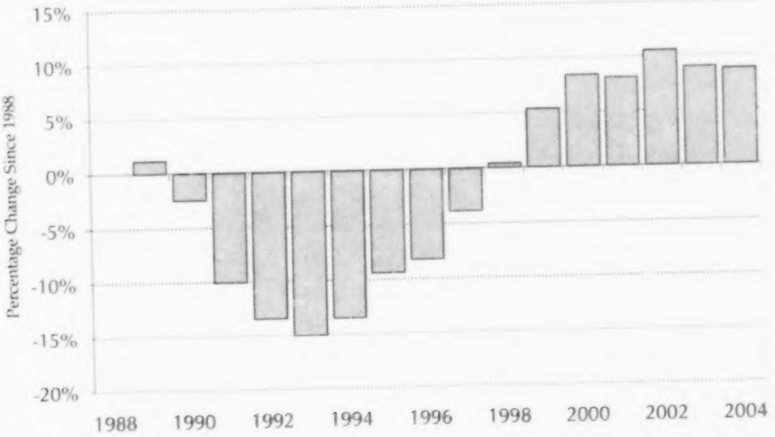
[1] Indeed, as a supporter of the Agreement, I felt that I numbered among the betrayers and that my three post-graduate degrees in economics had blinded me.

Figure 1: *Canadian Manufacturing Employment*

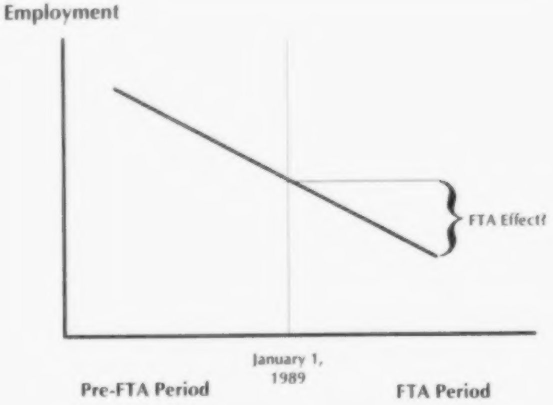


Source: Author's calculations based on labour force survey estimates, seasonally adjusted; Statistic Canada's CANSIM table number 282-0094.

Manufacturing employment today is significantly higher than in 1988 before the signing of the FTA — no mean accomplishment given the Chinese manufacturing onslaught that has crippled manufacturing employment in most countries in the Organisation for Economic Co-operation and Development (Figure 1).

It would be disingenuous to say that Figure 1 establishes the success of the FTA. Many things have happened since 1988 that potentially affected employment, including the GST, tight money and fiscal restraint. Two things are missing from the Figure 1 analysis. For one thing, the analysis is aggregative, failing to distinguish industries that were affected by the FTA, such as apparels, from those that were not, including the automotive sector. For another, for each affected industry, one needs to compare its FTA period performance with its pre-FTA performance. The problem is illustrated in Figure 2 which plots the time series of employment for a fictitious industry. If one were to look solely at the FTA period one would incorrectly attribute the long-term demise of the

Figure 2: *Secular Change*



industry to the FTA. What gives this example force is that apparels and other industries that were hurt by the FTA are low-end, labour-intensive industries that have been experiencing secular decline.

In Trefler (2004) I laid out an econometric methodology to deal with this and other problems that arise when estimating the impact of the FTA. Some key results appear in Table 1. For industries that were subjected to the deepest Canadian tariff cuts (import-competing industries), employment fell by 12 percent. Because of the high costs that displaced workers bear, that is a disturbing number. Unfortunately, these lost jobs were not picked up by the industries that experienced the deepest U.S. tariff cuts (export-oriented industries), for reasons that I shall explain.

The bright spot for the FTA was productivity growth. The most affected industries experienced productivity growth of 15 percent (Table 1). It must be emphasized that this is a huge increase. If the Canadian economy as a whole could grow by 15 percent it would all but close the Canada-U.S. income gap and provide the funds to meet every one of Canada's fiscal challenges, including health

Table 1: *Impact of the FTA on Manufacturing Employment and Productivity*

	Employment		Productivity	
	Effect of Canadian tariff cuts	Effect of U.S. tariff cuts	Effect of Canadian tariff cuts	Effect of U.S. tariff cuts
Total	-12%	-1%	15%	4%
Within/Between				
Within Plants	-12%	0%	0%	14%
Between Plants	0%	-1%	15%	-10%
Exporter Status				
Exporters	0%	0%	0%	10%
Non-Exporters	0%	-12%	0%	0%

Source: Lileeva (2004) and Trefler (2004).

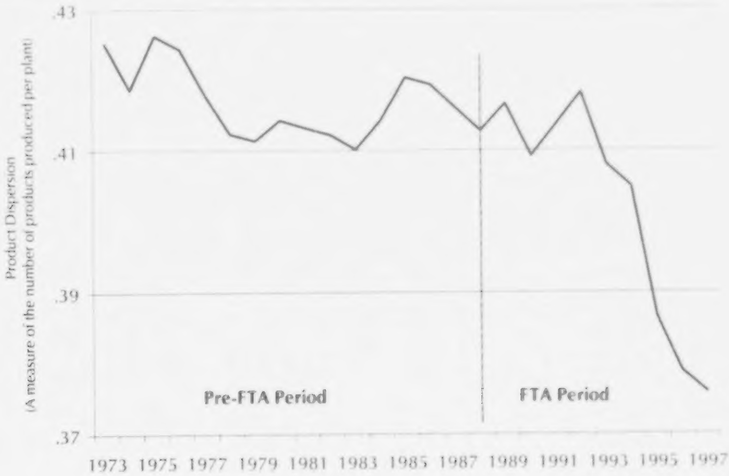
care, children, regional development transfers, single moms, Kyoto commitments, and a C.D. Howe Institute favourite, tax cuts. All of us should agree that a productivity increase of this magnitude is a good thing. It is amazing to me that a government policy could be so powerful.

The Commission's Predictions

The Macdonald Commission predicted the productivity gains. However, the Commission had a very particular view of where those gains would come from. Was the Commission right?

According to the Macdonald Commission, two things should have happened to promote productivity growth. First, companies should have rationalized their product lines. Then, each product line should have had a longer production run. Figure 3 shows that for manufacturing companies as a whole, product rationalization really did happen.

Figure 3: *Number of Products per Multi-Product Plant*



Source: Baldwin, Beckstead and Caves (2001).

The horizontal axis is a measure of the number of products produced by each multi-product manufacturing plant in Canada. Figure 3 shows a sharp downturn in the number of products produced in the FTA period. Of course, time-series data displays do not prove that this downturn was due to the FTA. Fortunately, careful analysis to be found in Baldwin Caves, and Gu (2005) and Baldwin and Gu (2004a) shows that this product rationalization was indeed driven by the FTA tariff cuts.[2]

The Macdonald Commission highlighted a second, related source of potential productivity gains: longer production runs for those products that survived rationalization. This is not evident in the data unless, once again, we look at exporters who faced falling U.S. tariffs. Thus, from a distance, the Macdonald Commission

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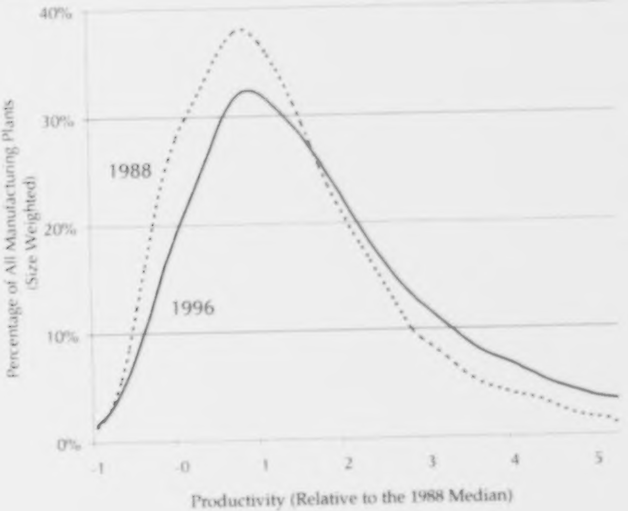
[2] It is worth pointing out that the Commission did not quite get this right. Product line rationalization was not widespread in manufacturing: Only exporters took advantage of rationalization as a route to increased productivity. I return to this point.

Figure 4: *Productivity Distribution of Canadian Manufacturing Plants, 1988 and 1996*



Source: Lileeva, 2004.

was right. However, the Commission also missed much that is important for understanding the effects of the FTA.

Plant-Level Heterogeneity: The New, New International Trade Theory

The key to understanding the effects of the FTA is to focus on plant heterogeneity. Not all manufacturing plants responded to the FTA in the same way. The first thing to notice is that the dispersion among plant productivities is huge. Figure 4 from my student Alla Lileeva (2004) at York University shows the distribution of plant productivities in 1988 and 1996. The first thing to note is that plants to the far right of the figure are eight times more productive than plants to the far left. This is indicative of enormous productivity heterogeneity across Canadian manufacturing plants. The second thing to note is how the distribution changed over the FTA period. It shifted right, which means that less productive plants either shrunk or closed, and more productive plants either entered or expanded.

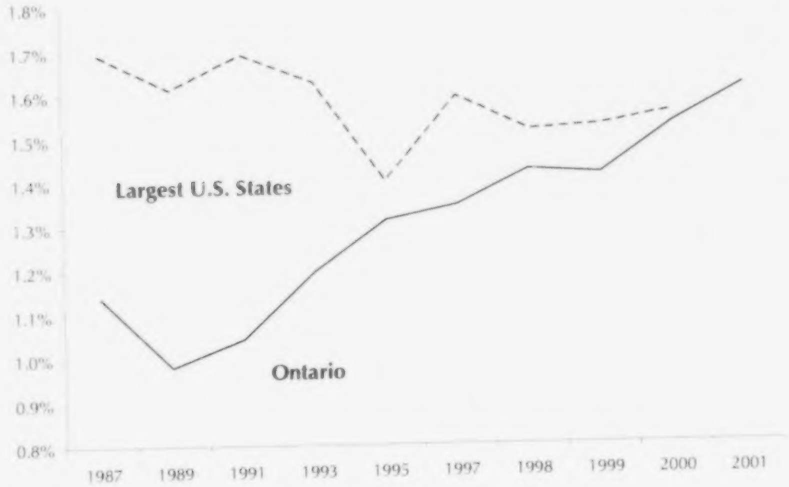
Baggs, Head and Ries (2003), Gu, Sawchuk and Whewell (2003), Lileeva (2004), and Trefler (2004) all show that the FTA led to the closing of less productive plants and to the entry of more productive ones. This work, together with additional results from Trefler (2004a), help us piece together the complicated industry dynamics that led to the FTA-induced productivity gains. As Table 1 shows, the Canadian tariff cuts led to a 15-percent rise in productivity among the most affected, import-competing industries. However, it did not lead to any rise in plant-level productivity. Thus, the industry-level productivity gains were a result of the closing of less-productive plants.

As well, the U.S. tariff cuts led to a 14-percent increase in plant-level productivity. This rise had nothing to do with productivity gains from the entry of productive plants. Indeed, the entry of plants actually reduced productivity because young plants are rarely as productive as older ones. This is the -10 percent number in Table 1.

The striking dimension of plant-level heterogeneity is the difference between exporters and non-exporters. It turns out that almost all of the plant-level productivity gains that have been documented can be traced back to exporters. As Baldwin and Gu (2003, 2004a) show, the U.S. tariff cuts led to productivity gains only among Canadian exporters (Table 1). As Baldwin and Gu (2004a) also show, while all plants rationalized production, only exporters experienced longer production runs for surviving products.

The behaviour of exporters also explains why there were not larger employment gains from the FTA. While exporters expanded output substantially, they did so without hiring new workers. Rather, they raised output by raising productivity. Thus, as Lileeva (2004a) shows, the U.S. tariff cuts had no impact on employment by exporters. However, because these exporters were also expanding in the Canadian market, non-exporters fired about 12

Figure 5: *Business R&D Expenditure as a % of GDP*



Source: Institute for Competitveness, Productivity and Prosperity (2004).

percent of their workforce. The net effect was lost jobs in the export-competing sector, not job gains. Thus, plant-level heterogeneity, which was not considered by the Commission, is central to understanding the productivity and employment dynamics set off by the FTA.

Firm Strategy: The New, New, New International Trade Theory

Why are plants so heterogeneous in their responses to international trade? Recent work points to the sophistication of corporate strategy. Figure 5 plots business-sector research and development (R&D) as a percentage of gross domestic product (GDP) for Ontario and for the 14 largest U.S. states, and shows that before the FTA was signed on January 1, 1989, Ontario companies were not doing nearly as much R&D as their U.S. counterparts.

What does this R&D information mean? In the case of the Vintners Quality Alliance (VQA) strategy of Ontario wineries, it means upgrading the product. While the volume of wine sold by Ontario wineries has not moved much since the signing of the FTA, the value has sky-rocketed. This is a much more general phenomenon than is at first apparent. Baldwin and Gu (2004b) provide evidence that plants that move into export markets do several things:

1. They increase investments in R&D.
2. They increase training programs.
3. They develop capacities for absorbing foreign technologies and international best practices.

When companies enter export markets, they increase the number of advanced technologies used, as well as the amount of foreign sourcing for advanced technologies. These companies also gain access to more information about advanced technologies. Entering export markets is associated with improvements in the novelty of the innovations that are introduced, as well.

At the end of the day, some companies succeed where others fail because they adopt sophisticated strategies that involve continuous upgrading and innovation. The FTA, by providing both pressure and support for Canadian companies, forced plants to adopt the kinds of strategies that raise productivity and encourage success.

Conclusions

The Macdonald Commission had the right idea. The FTA has been a boon to Canadian productivity. Of course, the Macdonald Commission did not foresee everything. The FTA led to considerably greater labour market disruption and lost jobs than was originally anticipated. At the same time, the mechanisms for productivity gain have been far richer than was understood by then state-of-the-art economic theories.

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International Trade:
Tinker or Transform to Re-energize the Canada-U.S. Economic Relationship

Michael Hart

The Macdonald Commission examined a wide range of issues related to Canada's economic and social circumstances, but its signature analysis concerned Canada's performance as a trading nation. In September 1985, the new Progressive Conservative government led by Brian Mulroney made free trade with the United States the centrepiece of its economic policy and a critical part of its continental strategy. The Canada-U.S. Free Trade Agreement (FTA), negotiated between 1985 and 1987 and implemented on January 1, 1989, largely followed the contours of the accord recommended by the Commission.

For the most part, the FTA worked out as predicted by its supporters. As business retooled in its wake, it fundamentally altered Canada's economic geography from an east-west to a north-south orientation. Business simultaneously accepted the need to move beyond its traditional reliance on resources to fuel exports and a protected manufacturing sector to supply domestic demand, and embraced a more flexible and more outward-oriented emphasis on higher-value manufacturing and services.

Nearly two decades later, Canadians face further choices. We are substantially better off than we were in 1984, but we remain an underperforming economy relative to the United States. Two broad streams of opinion are emerging (Hart 2004). Some commentators say the time has come to cast off the remaining barriers to the flow of goods, services and capital between Canada and the United States and negotiate, at a minimum, a customs union. Others say economic integration has already gone too far, placing at risk Canadian independence and sovereignty. Both sides are discussing the same point: the implications of geography, and not only physical geography, but also the economic and cultural geography of North America. The integrationists embrace geography and seek to achieve the best bargain from this reality of nature and product of history, while the rejectionists fear its implications and reject further integration. This chapter makes the case for a new assault on remaining barriers to further bilateral integration.

Governing Deepening Integration

The Canada-U.S. economic relationship is governed principally by the North American Free Trade Agreement (NAFTA) — itself an augmented version of the original FTA — and to a lesser extent by the agreements of the World Trade Organization (WTO). Both are based on an economic model in which trade occurs between unrelated companies and households, and goods and services that cross borders are destined for final consumption on arrival. They also assume that governments treat international trade as a politically arbitrated element of national policy. Accordingly, their central purpose is to set rules for government regulation of trade. This viewpoint is now outmoded.

In 1980, two-way bilateral trade in goods and services represented about 40 percent of Canadian gross domestic product (GDP). By 2000, that figure had nearly doubled: bilateral trade was valued at some $700 billion annually or $2 billion daily (all figures are in Canadian dollars unless otherwise noted). The economic slowdown of the early years of the 21st century reduced these values somewhat, but maintained the new plateau ushered in by free trade and did not alter the continued transformation of that trade from arms-length to integrated transactions. Today, previously imported components, concentrated in such sectors as machinery and equipment, transportation, electronics, plastics and textiles, make up a third of the value of Canada's total exports (Cross 2003). Value derived from licensing, investments and other non-goods transactions has also become more critical to cross-border economic linkages.

The FTA/NAFTA and the WTO were essentially liberalization agreements erected upon a regime of previously agreed and largely static rules. Both left unresolved within their spheres of relevance a range of issues. These include rules-of-origin, which restrict the full potential of NAFTA trade, anti-dumping and countervailing duties, supply management in agriculture and government procurement restrictions. In neither Canada nor the United States, however, is there much enthusiasm for devoting political resources to dealing with these leftovers. That is because the benefits of classic trade liberalization have now been largely realized between the two countries. On the other hand, the accelerating pace of economic integration has thrown up issues concerning regulatory divergence and border management that are beyond the competence of traditional trade agreements, but resolution of which would significantly enhance Canada's economic prospects.

The institutional infrastructure for the management of the Canada-U.S. relationship is astonishingly light — no political or policy oversight, no regular meetings between heads of government or foreign or trade ministers, no formal structure of committees looking at the relationship in a coherent and coordinated manner. The absence of a formal overall structure reflects a determined effort to treat issues in the relationship within vertical silos, with firewalls to prevent cross linkages. In part, this approach derives from Canadian fears that Canada would see its interests overwhelmed in any more formal relationship. It also reflects the U.S. system of government, which makes sustained coherence and coordination in both foreign and domestic policies extraordinarily difficult. Again, problems of deep integration point to the need for a more robust bilateral institutional structure.

In practice, Canadian and U.S. officials work closely to manage a vast array of similar, but not identical, regulatory regimes in areas ranging from food safety to refugee determinations. Officials — and in some cases ministers — rely on a dense network of informal cooperative arrangements to share information, experience and expertise with a view to solving cross-border problems, implementing mutual recognition arrangements, establishing joint testing protocols, and more (Hart 2003). Some of this activity is mandated by formal agreements such as the NAFTA, but most of it remains uncoordinated — the natural result of officials with similar responsibilities and a shared outlook seeking support and relationships as they pursue their own duties. Even so, the success of this activity also reinforces, subtly and indirectly, the integration of the two economies and points to the need for more formal arrangements.

After the terrorist attacks of September 11, 2001 — which caused major, if short-term, border disruptions — Canada and the United States agreed on a 30-point program of action, embodied in the *Smart Border Declaration*, to address the issues that the attacks threw into stark relief. The *Declaration* is interesting from two perspectives. For one thing, it covers four separate areas of border management — the movement of people, the movement of goods, infrastructure and enforcement — acknowledging challenges that have to be addressed in an integrated way. The aim is to "create a unique opportunity to build … a border that securely facilitates the free flow of people and commerce" (Canada 2001). For another, it is silent on issues left over from the NAFTA and multilateral negotiations concerning movement of goods. This emphasis reflects the fact that further growth of Canada-U.S. trade and investment depends upon the efficiency with which the border is managed rather than upon the removal of classic trade barriers.

Proximity and evolving commercial and official ties will ensure that the process of economic integration will continue, if only piecemeal. To gain the full benefits of further integration, the two governments require a process of more active, guided convergence. More specifically, they have to develop strategies that rely on joint or reciprocal enforcement of regulatory requirements, rather than on separate border administration. The two most critical border issues are security and regulatory compliance: In both cases, behind-the-border, co-operative strategies promise higher compliance and lower direct and indirect costs than do further changes in border administration alone.

Upgrading the NAFTA from a free-trade area to a customs union would reduce some regulatory requirements and eliminate some duplication. But a customs union will not create a single market or eliminate the need for active border administration because it does not address regulatory differences. Governments will still need a more challenging — and rewarding — program aimed at promoting and managing regulatory convergence and creating a zone of confidence around North America based on joint, cooperative, approaches to security.[1]

Both countries' transport departments, for example, might coordinate their efforts to gain mutual recognition of each other's approaches to highway safety. A good basis for this kind of cooperation already exists in the informal networks among officials and in the relatively minor differences in regulatory approach. What is missing is a mandate to resolve differences and a more formal institutional framework to ensure mutually beneficial policies.

Similarly, both governments maintain separate but similar drug approval procedures that reach almost identical conclusions within different time frames. Adopting a first-to-approve rule as a default position, for example, could lead to constructive regulatory competition, particularly if it includes a safeguard provision for sensitive issues. Establishing an international commission or other institution to supervise the transition to a more integrated regime, and to provide continuing oversight, would ensure that both governments maintained a voice in the drug approval process.

Establishment of such commissions can be phased in over time and, as with the existing International Joint Commission on Boundary Waters, ultimate authority would continue to rest with ministers. However, by appointing high-quality commissioners and pledging to maintain an arms-length relationship with them, the governments would foster a similar respected status for the new commissions. Such bodies may prove to be the key to creating a better functioning, jointly governed, integrated market.

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[1] While this paper is not the place to analyze the complex matters that would have to be addressed to create a zone of confidence, it is important to note that U.S. perceptions of a lax attitude by Canada toward security are a critical stumbling block to progress in this area. Much useful work has already been done, but U.S. political observers remain skeptical (Custred 2003).

Good Relations Matter

On the political front, the two governments and public attitudes have drifted apart in the last 10 years. This is a critical development, because the professionals can only manage the status quo; it takes political leadership to advance the agenda. Without that leadership, drift is inevitable. The United States can tolerate drift; while what happens in Canada is not unimportant, it does not touch people's lives sufficiently to become politically important. Canada cannot tolerate drift, however, because the U.S. connection is too important; if Canadians want to strengthen their security, improve their prosperity, or make the world a better place, they need Washington's support.

Canadians appear to have short memories. Twenty years ago we took a dare. We accepted our destiny as a nation of the Americas and as neighbour to the world's largest and most dynamic market, and negotiated a free-trade agreement. Clear economic benefits followed, with few of the collateral problems related to loss of national independence and identity that critics warned of. Canadians continue to exercise the choices they prefer, but from a more prosperous and economically sustainable base.

Over the following decade, two effective ambassadors, with the full support of the prime minister and his cabinet, built the basis for a productive Canada-U.S. relationship. That relationship made Canada's the best known and most effective Embassy in Washington, and was critical to success in resolving a range of issues, from the transformation of the FTA into NAFTA to acid rain.

In the following decade, however, Canada pursued a policy of seemingly deliberate neglect even before the accession of President George W. Bush, and differences over the Iraq war exacerbated matters. Occasional constructive efforts by John Manley, for example, during his brief tenure as foreign minister, could not lighten the sour mood. In 2004, newly installed Prime Minister Paul Martin responded to the growing unease over the relationship by forming a cabinet committee and appointing a parliamentary secretary on Canada-U.S. relations. More than a year later, however, Mr. Martin had yet to define the purpose that he wants better relations to serve. Until he does, they will continue to drift. Better personal relations between leaders may be a necessary condition, but it is not sufficient to return to the constructive and effective relations that are needed to address the emerging agenda.

Canadian Interests and the Emerging Canada-U.S. Agenda

Canada has been an integral part of a North American security perimeter since the late 1930s and it is now equally part of the North American economic perimeter. With some 75 percent of its trade conducted with the United States, it is idle chatter to contend that Canada has a choice of living either inside this perimeter or outside it. That choice has been determined by geography and reinforced by more than three generations of policy.

Over the past 20 years, some important lessons have emerged about public policymaking that are pertinent to managing Canada-U.S. relations and using that relationship to advance Canadians' interest in a more secure, prosperous and fair world. Among them:

Royal Commissions can be important catalysts to policy change. In the 20th century, three royal commission reports played a critical role in transforming public policy in Canada: the 1939 Rowell-Sirois Report, the 1958 Gordon Commission, and the 1985 Macdonald Commission. Each came at a critical point in Canada's evolution as a nation and each provided critical advice and analysis on central policies of governance. Canada could now be well served by the appointment of another royal commission with a mandate to look into the challenges of revitalizing Canada-U.S. relations, with particular emphasis on the twin challenges of addressing deepening integration and post-9/11 security concerns.

New governments carry less baggage. Looking back over the past quarter century, it is clear that the change of government in 1985 was critical to transforming Canada. It is open to debate whether Paul Martin and his team represent a government with the political leadership needed for bold change. All the more reason, therefore, for the analytical community to redouble its efforts and consider the problems, the opportunities, and the means to address Canada's long-term security and prosperity interests in building a more dynamic and constructive partnership with the U.S.

We need a supportive Canada-U.S. political alignment. Many Canadian pundits and policymakers appear to believe that Canada can only make progress when the Democrats are in power pursuing an internationalist agenda that fits with Canadian values and priorities. Whether the two societies have similar views on human rights, global warming, gay marriage, abortion, school prayer or welfare reform may be interesting; what counts in bilateral relations, however, are attitudes toward security, the market, and the border. A Republican administration is perhaps more likely to pursue cooperative efforts to resolve security issues at the border and economic issues more generally. Whatever their political preferences may be, Canadians and their government need to work with whoever occupies the White House or leads the Congress.

Good bilateral relations with the United States require more than a return to civility. Mr. Martin has expressed a desire for a more civil relationship with the United States without defining the purpose to which he wants to put restored civility. Until he does, the relationship will maintain its drift. The overall lesson of the past 20 years is that Canada-U.S. relations have to be managed with eyes on both the perils and the benefits of deep integration and proximity. To reap the long-term benefits will require tackling border administration, regulatory differences and institutional capacity. In both countries, various groups are beginning to put flesh on the bones of this emerging agenda. Success in addressing these three interrelated issues will require strong political leadership and significant government and private resources.

Canada's business community should lead and speak forcefully. Canadians' acceptance of bilateral free trade was significantly influenced by the business community's conversion to an idea that had always made economic sense but that business did not believe served its interests. Business today fears that U.S. preoccupation with security, and Canadian reluctance to respond effectively, will undermine confidence in Canada as a secure place to invest to serve the larger North American market. But business leaders do not appear to fully appreciate the extent to which economic integration, border management, regulatory convergence, institutional capacity and security all require a new accommodation with the United States. Without strong and sustained support from business, this nexus of issues is unlikely to attract the kind of attention required to translate ideas into shared policy priorities.

Managing public diplomacy has become more important. One of the lessons from the negotiation of the FTA was that important matters of public policy should be thoroughly and publicly discussed, and that the discussion requires an informed media and electorate as well as a political and bureaucratic capacity for maintaining perspective. Since then, the Internet has made public policymaking more transparent, enabling government to communicate more effectively and more directly with interested constituencies and to become less directly reliant on the media. However, the Internet has also given a disproportionate voice to marginal interests that move very few votes. In a democracy it is votes that count, and managers of the Canada-U.S. file have to keep this fact in view.

Democracy works; citizens know what they want. Given time and information, the majority of Canadians will come out in the right place. They have become increasingly at ease with freer trade and related policies and accept that the time has come to go further and address the challenges of deep integration (Hart 2004). They are ready to follow. What is missing is confident political leadership.

Conclusion

Canada and the United States face a historic challenge: Do they continue on the path of co-operation in promoting more secure and more prosperous North American societies or do they pursue divergent and, ultimately, less secure and less prosperous, courses? To ask the question is to answer it — and yet, if important decisions are not taken soon, the two countries may find themselves on divergent paths. Such a development would be a tragic mistake, one that can be avoided if the two governments commit to deliberate and co-operative steps that will enhance the security and the prosperity of their citizens.

To get there, they have to face a number of realities. For one thing, they already share a perimeter. It is defined by geography, economics, demographics, common political and societal values, common security arrangements and challenges, and joint economic arrangements and goals. For another, broad convergence already exists across a wide range of policy areas, including security and immigration. The differences that exist lie in administration, not in fundamental concepts. While people in either country may at times want to celebrate their differences, all need to recognize that they also share many common values and goals, and that what is needed is not homogenization but more sharing of information and co-ordination of decisions in areas where the two governments have common objectives.

There will be deepening integration between the two countries across nearly every area where the two societies connect. The issue for governments is whether to help or hinder that integration, manage it or let it drift. Any initiative to manage integration has to be comprehensive in scope, and its results must be enshrined in a formal agreement. The exigencies of the highly fragmented U.S. political system make it difficult for United States officials to accommodate foreign interests issue by issue, while the capacity to exercise raw power makes it relatively easy to insist that foreign governments accommodate single-issue U.S. interests. Broad agendas and formal agreements help to reduce this disparity in power.

The challenge for Canadians and their U.S. counterparts is to exercise, rather than guard, their sovereignty by anticipating change and preparing options that promote each other's interests. For Canadians, a smart future lies not in imitating what the U.S. does, but in astutely leveraging the advantages of proximity to the world's leading power and largest economy. The options are clear. Canada and the United States must take deliberate steps to bring the architecture of their relationship into line with the challenge and fact of deepening interdependence as well as with the political and security realities ushered in by the events of September 11, 2001.

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Federalism and Canada's Economic Union:
What the Report Said

Alan Cairns

The Macdonald Commission was given a generous mandate. In our more despairing moments the researchers reworded it as "The universe is in trouble, please advise." Specifically, the Commission confronted the evolved form of Canadian constitutional arrangements that had its roots in the very different world of the mid-19th century. As well, the difficult hurdle of formal constitutional amendment acted as a defence of the status quo. This was supplemented by the inertia of arrangements which, while clearly causing problems — leading to the creation of the Commission — were still not on the point of collapse.

My paper covers much of the Report's Volume 3. There are far more detailed recommendations there than I can usefully discuss in the space available.[1] So I have retreated to the perhaps safer vantage point of laying out the larger picture of the changing institutional and constitutional direction in which the Commission wished to take the Canadian people.

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[1] For example, the Commission proposed restructuring central agencies to facilitate regional input to the cabinet, and recommended that federal agencies and departments be decentralised for policy planning (pp. 92-95). The Report suggests that Parliament and provincial legislatures have the capacity to delegate legislative powers to each other (pp. 256, 473), recommends constitutional changes so the parties to federal-provincial accords can bind their successors (pp. 258, 473), and proposes a constitutional amendment enabling provincial obligations flowing from international treaties to be applied following legislative resolutions by two-thirds of the provinces representing at least half the Canadian population (p. 154). The Commission also proposed enlarging the scope of Sec. 121 to cover services and non-tariff barriers, as well as tariffs (pp. 10, 19).

This focus is a helpful reminder that, although the economy was clearly the primary concern of the Report, the Commission also proposed a major transformation in how Canadians governed themselves. Indeed, it can be argued that the Commission's own analysis indicated that without the institutional changes it proposed, its economic goals were imperfectly attainable.

The Commission Report clearly and powerfully argued that many of our institutional and constitutional arrangements were dysfunctional.

> Commissioners have concluded...that while parliamentary government, federalism and the Charter are appropriate to Canadian values and to the handling of future demands, our institutions since 1945 have not yet successfully adapted to major changes in the environment. Indeed, there have been such significantly negative effects that co-ordinated reform is required to ensure that Canada's constitutional order is both effective in managing the nation's collective affairs and sensitive to the values of liberal democracy (Volume III, p. 4).

Indeed, commissioners "fear that some recent developments threaten the function of governments as servants of the people" (p. 5). Specifically, the Report argued that the management of intergovernmental interdependence was sporadic, ad hoc and required more coordinated systematic attention (p. 474).

With the inter-governmental confrontations of the 1970s fresh in their minds, the commissioners concluded that the federal system was in disarray. Nation-building and sovereigntist aspirations in Quebec, and the more generalised centrifugal pressures associated with province-building in the rest of Canada, had destabilised the federal system. Of particular concern was the fact that these developments put the federal government on the defensive.

The leadership role of the federal government, focused on the pan-Canadian dimension of Canada's existence, was frustrated by Ottawa's inability to convincingly claim that it represented and could legitimately speak for the regional and provincial diversity of the country. The inability of the federal government, for structural reasons, to incorporate and blend the diversities inherent in federalism into its country-wide leadership role encouraged the provincial governments — especially from parts of the country weakly represented in the governing party — to assert a monopolistic claim to represent the provincial dimension of their citizenry.

The Report responded to the centrifugal challenge of provincialism by stressing the need to support the Canadian dimension of our identity, of our citizenship, of our economy, of our rights. To the commissioners, these dimensions of our being were beleaguered. As a result, a fundamental political goal of the Report — to reinvigorate the leadership role of the federal government — is indelibly linked to the reciprocal goal of strengthening a pan-Canadian identity against the centrifugal pressures that threatened its emasculation. The Commission sought a more focused, leaner, less fractious Canada in which the legitimacy of the federal government had been restored by the institutional changes it recommended.

The seriousness of these structural problems was heightened by the major challenge confronting Canada in adapting to the international economic environment, largely by free trade with the United States, which the Commission proposed. The free trade proposal not only suggested a wrenching challenge to a Canadian identity that historically looked across the Atlantic to Europe — the better to avoid the embrace of the United States — but required, the commissioners argued, a much more adaptive and flexible capacity in polity, society and economy.

Cumulatively, these challenges suggested the need for more coherent constitutional and institutional arrangements that would fit Canadians for living in a more competitive economic world in which the market would play an enhanced role, less influenced by state planning than had been the case in the past (p. 157; see also p. 142). In a seeming paradox, the Commission favoured both a strengthened federal government and a market less subject to state direction.

In the remainder of the paper, I will fill in some of the details behind this portrait and present the commissioners' recommendations to move Canada off what they saw as a destructive path.

Executive Federalism and Regionalism

The Commission identified the growth of government at the federal and provincial levels as a main contributor to the crisis of Canadian federalism. Competitive state building — province-building in English-speaking Canada, country-building in Quebec and the traditional Canadian nation-building under federal leadership — generated, the commissioners argued, an acrimonious interdependence that had to be constrained.[2]

Interdependence led to the new institution of executive federalism in the post World War II era which, in an ad hoc manner, and with only limited success, sought to reconcile the conflicting visions of federal and provincial governments. As well, the making of policy in the closed inter-governmental forums of executive federalism led to what we now call a democratic deficit in which legislatures were side-tracked and citizen-based democracy eroded.

From the federal government perspective, executive federalism and the rival visions which fed into it had two major flaws. It had not developed the effective capacity to manage the economic union which the Commission thought necessary. At the same time, executive federalism suggested that provincial governments were the sole representatives of regional or provincial interests (p. 70).[3] Commissioners concluded that various federal-provincial ministerial councils in key policy areas had to be created to facilitate more cooperative behaviour in the inter-governmental arena.

On top of that, and of more immediate importance, the commissioners were deeply concerned about the ability of the federal government to respond effectively to province-building and Quebec nationalism. At a time when provincial governments claimed to be the sole or primary advocates of provincial and regional ambitions and concerns, the federal government was weakened by the regionally unrepresentative nature of the government party caucus. When the Liberals were in power, the West — including

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[2] The second major challenge to Canadian constitutional arrangements was the increasing impact of the international environment.

[3] The Commission also argued that, although there were many inter-governmental bodies, the meetings were sporadic and lacked co-ordination.

British Columbia — was typically absent or only minimally present in the governing party.

When the Conservatives were in power, representation from Quebec was often strikingly absent. As a result, the capacity of the federal government to challenge the claims of provincial governments from the disaffected parts of the country was gravely weakened. "Persistent regional imbalances in national institutions," the Report asserted, "can ultimately strain the very fabric of Confederation" (p. 81).[4] As an extensive body of political science literature noted, the federal government's weakness was partly due to the low level of voter support for the governing party in areas where its representation was weak or non-existent. This weakness at the polls, however, was profoundly aggravated by the first-past-the-post electoral system, which brutally punished parties that, even if they received respectable shares of the popular vote, might receive a negligible number of seats. The fact that the partisan distribution of seats in the Commons failed to mirror the geographic distribution of party votes in the country — indeed, grossly distorted it — weakened the legitimacy and capacity of the federal government in challenging the provincial government-led centrifugal pressures in federalism (pp. 77, 80). Accordingly, measures were necessary "to strengthen the political legitimacy of the central government" (p. 92).

This federal government weakness of regional representation, which was attributed to the electoral system, was reinforced by two additional factors: the weakness of the Senate as a representative of provincial interests and an intellectual blindness that led Canadians to think of federalism in terms of the division of powers to the relative neglect of concern for regional representation at the centre (p. 72).

The weakness of the Senate was attributed to its anachronistic regional composition and to the fact that its members were appointed by the federal government. Either of these was adequate to undermine any claim that the Senate — especially in an era of province-building — could speak for the aspirations of provinces.

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[4] Elsewhere, the Commission stated that "our national institutions have been seriously flawed [in terms of regional representation and that it was]...not an exaggeration to speak of an institutional failure which has had profound consequences for the governance of Canada" (p. 72).

Proportional Representation and Senate Reform

On the basis of this analysis, a central task of the Commission was to strengthen the federal government, to reinvigorate a national Canadian voice, and to give the federal government the capacity to claim that it too spoke for provinces and regions of Canada. The significance of this goal for the Commission cannot be exaggerated.[5]

The Commission canvassed two possible remedies for the incapacity of the federal government to represent regional-provincial interests: proportional representation (PR) for the Commons and Senate reform, which would also include PR. The commissioners opted for a proportionally elected Senate over electoral reform for the Commons on the ground that such change for the House would damage the leadership capacity of the federal government by the minority, or coalition, governments to which it would lead (p. 85).[6] Accordingly, the Commission opted for a reformed, elected Senate, based on proportional representation in multi-member constituencies (p. 82). Further, the Commission revamped the regional base of Senate representation, proposing 24 members from Quebec and Ontario, six from PEI, four from the Northwest

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[5] The Commission argued that the weak representation of the governing party in certain regions "has lent credibility to the provincial claim to represent these areas, even in national policy" (p. 263; see also p. 81). "Better regional representation" within the national government, the Commission argued, would "increase the legitimacy of the national government in intergovernmental affairs" (p. 8).

[6] Proportional representation for the House of Commons was called "our second choice" (p. 7). Commissioners stated that "reform of the electoral system for the House of Commons is not practicable at the present time. Such proposals have received little evident public support" (p. 85), a statement that could not convincingly be made now.

Territories, two from the Yukon, and 12 from the remaining provinces, for a total of 144 (p. 464).

The virtue of this proposal was that it would leave the responsible government character of the Cabinet and House of Commons arrangement intact. It would, however, diversify the regional representation in the government caucus by the addition of Senators elected under PR. This would enlarge and make more regionally representative the pool from which ministers could be selected. As a result, the public face of the federal government would be more reflective of the regional base of its partisan support.

The strategy was to regionalise the centre by Senate reform, without decreasing the likelihood of strong majority governments, as would occur under PR for the House of Commons. The explicit purpose was to enhance the capacity of a revamped, more regionally sensitive federal government to resist the centrifugal pressures driving the federal system in a provincialist direction.[7]

The Economic Union

The second area of major reform was the management of the economic union:

> An economic union represents an advanced stage of economic integration. It involves the removal of customs duties among participating jurisdictions, the creation of a common external tariff, the elimination of barriers to the free movement of goods and the factors of production (labour and capital), and the harmonization of economic policies (p. 109).

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[7] Although the Senate would continue to be a chamber of sober second thought, its primary function would be to bring regional responsiveness to the federal government. The Report also argued that the Senate should be a dualist, as well as a regionalist, body, with the task of reconciling the "interests of French- and English-speaking Canadians." Hence, "on matters of special linguistic significance, passage of a law would require the support of both a majority of the Senate and a majority of francophone members." This would be achieved through an absolute, not a suspensive, veto (pp. 87-92).

Although the commissioners did not accept that the movement of goods and services in the Canadian economy was "restrained significantly by existing barriers" (p. 109; see also pp. 120, 133, 135, 465), they argued that barriers which may be economically trivial may nevertheless be politically significant in terms of our conceptions of Canadian citizenship (pp. 114, 135, 465). This political dimension of the economic union, the sense of belonging to a common country which it entailed, was clearly central to the Commission's vision.[8]

From this perspective, the intergovernmental conflicts of the years immediately prior to the Commission's appointment in 1982 had a powerful influence on the Commission — the 1976 election of the Parti Québecois, the Quebec referendum of 1980, the bitterness and acrimony which attended the agonised constitutional introspection culminating in the 1982 Constitution Act, and the Ottawa-Alberta confrontation over energy.[9]

In the commissioners' eyes, province-building, in both its political and economic dimension, had become one of the most striking features of Canadian federalism, manifested in a "high level of federal-provincial conflict" (p. 145). By the early 80s, they argued, it was obvious "that the hostility and confrontation over energy and other issues had gone too far" (p. 151).

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[8] "The objective of building a Canadian economic union has meaning because we are first a national political community. Threats to the economic union are threats to the national community because they erode the ties of affinity and interest that bind Canadians together" (p. 100; see also pp. 143, 182, 216-17, 243 for more on citizenship obligations).

[9] "[B]attles over constitutional and energy issues tended to poison the whole range of intergovernmental relationships, turning the process into one of 'good guys' versus 'bad guys'" (p. 264). This view was also explicit in Prime Minister Trudeau's original press announcement of one of the Commission's tasks. "If we are to prosper, we must find ways to lessen the clamour of federal-provincial argument, and to reach consensus with far less pain...[I]f this is to be achieved, we must ensure that national policies are designed so that all parts of Canada can benefit from them, and that national institutions are truly reflective of regional needs" (Scott 1986). Simeon and Robinson (1990) provide an excellent analysis of the crisis of Canadian federalism, which preceded the appointment of the Macdonald Commission.

The commissioners did not find the answer to destructive inter-governmental conflict in an imperialistic centralization (p. 148), harking back to a John A Macdonald vision of the country, but in a battery of intergovernmental councils (p. 474). They proposed that the First Ministers' Conference (FMC) should be entrenched in the constitution with an obligation to meet annually (p. 265). A critical task of the FMC would be the appointment of a number of Councils of Ministers in major functional policy areas. They would be served by permanent committees of officials, with the hoped-for result of establishing trust among the participating governments (p. 266).

The Commission proposed three major councils:

- The Council of Ministers of Finance would become a legal entity.
- A Council of Ministers Responsible for Economic Development would monitor and assess the state of the Canadian economic union, and help develop "a common set of purposes that will lead to co-ordinated effort in all the economic development activities in which governments engage" and which might develop "a Code of Economic Conduct" (p. 267; see also p. 137). This Economic Development Council would be supported by a Federal-Provincial Commission on the Economic Union which would monitor the union, identify barriers and possible areas for greater harmonization.
- The third major body overseeing the economic union would be The Council of Ministers on Social Policy (p. 268), which received less attention in the Report.

The Commission also proposed that Parliament and the legislatures should establish permanent standing committees responsible for inter-governmental relations to enhance accountability to legislatures and voters (p. 475).

The commissioners' goal was "to rationalize the structure of inter-governmental relations...to facilitate management of interdependence in the federal system"(p. 271). As well, the Commission explicitly noted that its three proposed Councils of Ministers were not intended to be exhaustive, but were part of a preliminary list.

The Commission's Philosophy

The Commission's overall constitutional philosophy was summed up in its thesis that Canada needed both the reform of national institutions and the reform of inter-governmental relations.

> Enhanced regional representation in national institutions is not a substitute for inter-governmental relations. The existence of a formal division of powers and of two strong orders of government means that co-ordination is essential, no matter how regional representation in national institutions is achieved (p. 271; see also pp. 7, 8, 71).

However, the Commission was clear that a more regionally sensitive Ottawa would change the nature of inter-governmental relations to its advantage.

To regionalise the centre meant that the federal "government will be able to provide more effective leadership and to counter the claim that provincial governments are Canadians' only legitimate representatives of local interests; one consequence of the present regionally imbalanced structure of representation in national institutions has been the almost impossible burden it placed on the inter-governmental process" (p. 272).

In short, the Commission proposed an integrated package of constitutional and institutional change with respect to the composition of the national government, and to the relationship of federalism to the economic union. In particular, the Commission proposed new institutions to facilitate "a more highly developed sense of constitutional co-existence and of comity, to moderate the excesses of rivalry and competition" (p. 21).

Its proposals were inter-dependent. If, for example, the federal government proceeded with the various councils of ministers, which could be achieved without resort to constitutional amendment, but was unable to implement Senate reform because of an inability to get the necessary constitutional amendment, some of the rationale for the ministerial councils would evaporate. A federal government deprived of the regional sensitivity that Senate reform was to produce would be unable to play the strong leadership role in the various ministerial councils that the Report proposed.

In fact, if regionalising the centre did not occur, the ministerial councils, deprived of the leadership of a regionally sensitive federal government, might become arenas for the expression of the very centrifugal pressures they were intended to constrain. The conclusion, therefore, appeared to be that Senate reform, which would be very difficult to achieve, was the linchpin in holding the Commission's macro-institutional-constitutional proposals together.

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Federalism and Canada's Economic Union:
The Past 20 Years

Geoffrey Hale

Canada's economic union evolved gradually during the past 20 years, rather than being transformed by the effects of globalization and North American integration. Canadians contemplated significant changes to the economic union during the constitutional reform debates of 1985-to-1995. However, they ran aground on the shoals of competing agendas and the requirements for unanimous consent embedded within the Meech Lake and Charlottetown Accords. As a result, subsequent changes to Canada's economic union have generally been incremental, consensual and worked out on a sector-by-sector basis.

This chapter examines some of the parallels between the processes shaping North American economic integration inspired by the Macdonald Commission and the dynamics of Canadian federalism which together have shaped these changes during the past 20 years. Instead of advocating uniform national policies, the Commission's approach to reconciling the economic union with the practices of federalism anticipated several major concepts that are central to the continuing integration of North American economies.

For one thing,, the methods used to enhance Canada's economic union have much in common with those used to encourage greater economic integration within North America. This process reflects the reality that obtaining political support for global or continental economic integration is often a two-level process that requires governments to build workable coalitions both within their own countries and in dealings with other governments and related societal interests (Cameron and Tomlin 2000; Hale and Kukucha forthcoming).

For another, instead of attempting to create or impose uniform policies, both sets of processes are based on negotiations intended to facilitate varying degrees of policy coordination and harmonization across political boundaries. These processes are sometimes described as negative integration: the encouragement of mutual accommodation and recognition among states in pursuing certain policy goals by "creat[ing] a framework of rules prohibiting certain forms of behaviour while accommodating a range of policy differences" (MacDonald, 2001, 139).

As well, these approaches have been reinforced by Canada's constitutional division of powers and the need to develop workable non-constitutional approaches that avoid the unanimous decision-making rules that torpedoed most proposals for constitutional reform after 1985. These processes resulted in relatively modest changes to the workings of federalism and Canada's economic union — but they may well have strengthened the capacities of both federal and provincial governments to adapt to North American economic integration.

This paper will examine the application of the Macdonald Commission's ideas to the renewal and strengthening of Canada's economic union during the past 20 years in three specific areas:

- The incremental reduction of barriers to domestic economic activity through structural reforms to federal regulatory and sector policies and the implementation of the Agreement on Internal Trade;
- The emergence of greater inter-provincial cooperation in the regulation of securities markets; and
- The adaptation of the federal-provincial tax collection agreements to reduce incentives for destructive tax competition, while giving provinces greater freedom for policy experimentation and the accommodation of regional priorities.

Trade, Capital Markets and the Economic Union

The Macdonald Commission's recommendations for increased inter-governmental policy coordination to strengthen the economic union have been most visible in various aspects of micro-economic policy — particularly sectoral issues related to international and inter-provincial trade and investment. However, this progress has been incremental, uneven, and dependent on the persistence of political will at both levels of government.

Key policy initiatives have been taken in three major areas:

- Reforms to federal sector policies and regulatory systems that restricted domestic competition and adjustment to structural economic changes;
- The negotiation and gradual implementation of the Agreement on Internal Trade, and
- Increased inter-provincial coordination of regulations governing capital markets, the securities industry and other financial sectors within provincial jurisdiction.

After 1985, the Mulroney and Chrétien governments took action, often in consultation with their provincial counterparts, to eliminate or reduce a series of federally induced economic distortions identified by the Macdonald Commission (Volume III, pp. 116-119). These included grain (and other) transportation subsidies and regulations, energy subsidies and price controls, and regionally specific tax incentives and subsidies. Changes to intergovernmental transfer policies and regionally specific subsidies for Unemployment Insurance have been addressed in other parts of this book.

More sporadic progress has been made by provincial governments in addressing such non-tariff barriers (NTBs) as preferential provincial procurement policies, industrial subsidies, trucking regulations, business licensing standards, and restrictions on inter-provincial trade in beer and liquor.

In some cases, governments capitalized on the phasing-out of regional subsidies to promote structural adjustments, such as the

Table 1: *Government Subsidies in Canada: 1992 – 2001*
(Adjusted for inflation, population; 1992=100)

	Federal		Provincial	Local	Total
	Agricultural	Total			
1992	100.0*	100.0	100.0	100.0	100.0
1993	23.3	75.9	83.6	101.0	81.8
1994	16.3	71.8	73.7	96.7	74.7
1995	14.6	66.1	61.3	94.1	65.8
1996	15.2	64.0	59.4	91.9	63.8
1997	19.2	79.3	54.9	88.4	66.8
1998	19.6	72.0	67.9	72.7	69.4
1999	31.2	67.0	68.7	78.5	68.5
2000	39.3	67.4	80.2	77.9	75.2
2001	46.5	69.0	131.2	76.1	101.7

Sources: Statistics Canada (2001, 2004), Provincial Economic Accounts, Cat. 13-213-PPB (Ottawa), Table 15; author's calculations

*1992 Agriculture subsidies included lump-sum transition payments to compensate for loss of subsidies; 1993 subsidies were 39.7 percent of 1991 levels, adjusted for inflation and population change.

restructuring of Canada's meat-packing industry, the diversification of Western agriculture, and then-Premier Frank McKenna's assiduous use of federal infrastructure funds to promote the diversification of New Brunswick's economy.

However, since 1997, both business and agricultural subsidies have increased significantly in several provinces — more than offsetting relative fiscal discipline at the federal level (Table 1.) The persistence of those targeted business and agricultural subsidies that the Macdonald Commission identified as obstacles to economic competitiveness points up the challenge of liberalizing sectoral policies in the absence of negotiated international rules that can serve as effective sources of policy discipline.

The sustained interaction between Canadian federalism and international trade negotiations has been a major factor in fostering federal-provincial cooperation. The extension of international

Table 2: *Agreement on Internal Trade*

"Architecture" Chapter	"Horizontal Rules" Chapter	"Sectoral Rules" Chapter
1 — Operating Principles	5 — Procurement	9 — Agriculture & Food
4 — General Rules	6 — Investment	10 — Alcoholic Beverages
16 — Institutional Provisions	7 — Labour Mobility	11 — Natural Resources Processing
17 — Dispute Resolution Procedures	8 — Consumer-Related Measures and Standards	12 — Energy (no consensus)
	15 — Environmental Protection	13 — Communications
		14 — Transportation

Source: Brown, Douglas M. 2002. *Market Rules: Economic Union Reform and Inter-governmental Policy-Making in Australia and Canada*. Montreal-Kingston: McGill-Queen's University Press.

trade regimes has also stimulated federal-provincial and interprovincial cooperation in identifying, mitigating and reducing barriers to internal trade, investment and labour mobility. A collaborative approach is necessary because provinces are exempt from a number of the North American Free Trade Agreement (NAFTA) rules governing national governments in such areas as procurement, agricultural marketing boards, restrictions on the export of unprocessed natural resources, and the regulation of financial services (Brown 2002).

The negotiation of the Agreement on Internal Trade (AIT) in 1993/1994 was a second-best strategy to reduce inter-provincial trade barriers within Canada following the repeated failure of constitutional reform negotiations between 1987 and 1992. The AIT's language was explicitly based on the models of national treatment, non-discrimination and, to a lesser extent, mutual recognition already established in international trade agreements. It also provided for several broad exemptions consistent with existing provisions of the General Agreement on Tariffs and Trade (Canada 1995).

The AIT was structured as an inter-governmental agreement limiting legal resort to the courts — as suggested in the Macdonald Commission's proposal for a Code of Economic Conduct. The gradual implementation of these measures has led to the institutionalization of more than a dozen federal-provincial and interprovincial committees at both ministerial and inter-departmental levels to oversee the workings of the AIT and to apply its 11 horizontal and sectoral chapters (Table 2).

The AIT also provides for the formation of dispute resolution tribunals, modeled on the provisions of NAFTA's Chapter 19, to hear appeals of disputes over the application of federal or provincial laws that are subject to the Agreement. In some cases, the application of AIT processes has led to changes in federal and provincial policies[1] — notably in the MMT (or Ethyl Corp.) case and in an AIT tribunal ruling which led to the overturning of Ontario's restrictive rules governing the recognition of extra-provincial accountants' credentials (Lemieux and Stuhec 1999).

The AIT committee structure has resulted in varying degrees of progress towards the identification and removal of barriers to trade in goods and services, depending on regional political sensitivities and priorities. Incremental progress has been made in the field of government procurement and several other areas of regulatory harmonization, including investment and consumer-related measures. Between 1999 and 2002, AIT provisions were extended to include the Municipalities, Universities, Schools and Hospitals (MUSH) sector and most commercial government enterprises, except for electrical utilities. The value of government contracts subject to geographic eligibility requirements has been cut by about two-thirds[2] since 1995 (Canada 2001). In other sectors, such as energy and electricity regulation, fundamentally different provincial interests and regulatory structures have precluded substantive change in inter-provincial trade rules despite widespread changes in broader electricity sector policies (Doern and Gattinger 2003).

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[1] Internal Trade Secretariat (2001), "Report of the Article 1716 Panel concerning a dispute between the Certified General Accountants Association of Manitoba and Ontario regarding the *Public Accountancy Act* (R.S.O. 1990, Chapter P. 37) and Regulations" (Winnipeg: October 5), Available at www.intrasec.mb.ca/pdf/cga_on_e.pdf. This ruling has prompted similar actions by CGAs in New Brunswick against restrictive practice regulations in Quebec.

As a result, for some observers, the AIT glass is half-full. For others, it is at least half-empty. Recent Statistics Canada research notes that inter-provincial trade increased as a percentage of GDP between 1992 and 2002 — particularly in smaller provinces — although the rate of increase in international exports has been substantially greater (Table 3).

Capital Markets and Securities Regulation

Changes in international capital markets and related regulatory regimes during the 1970s and 1980s have created an environment of almost continuous change in Canadian, North American and international capital markets since the mid-1980s. However, despite the crumbling of the four pillars constraining bank ownership of trust companies and securities dealers, the legislative structures governing Canada's financial sector and capital markets have been relatively slow to adapt to changing market conditions or to the demonstration effects of policy changes in other major industrial countries (Harris 2004).

Regulatory coordination takes place through the agency of the Canadian Securities Administrators, an inter-provincial body com-

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[2] Between 1995/1996 and 1999/2000, the volume of government contracts over minimal threshold values not subject to the AIT's provisions had dropped to 2.8 percent from 9.2 percent of total procurement — with the federal government providing the lion's share of the gains. A single window electronic tendering service — Marcan — has been set up to provide access to contracts tendered by the federal government, all provinces, and most related agencies. However, updated provincial reporting of procurement statistics remains spotty.

Table 3: *International and Inter-provincial Exports as a Share of GDP: 1992-2002*

	Ratio of Exports to GDP				Ratio of International to Inter-provincial Exports	
	International		Inter-provincial			
	1992	2002	1992	2002	1992	2002
Canada	26	38	19	20	0.73	1.90
Ontario	31	46	19	19	1.63	2.42
New Brunswick	26	43	26	32	1.00	1.34
Newfoundland and Labrador	19	40	10	20	1.90	2.00
Saskatchewan	28	37	23	28	1.22	1.32
Alberta	27	35	23	24	1.17	1.46
Quebec	21	35	19	20	1.11	1.75
Prince Edward Island	14	28	30	26	0.47	1.08s
Manitoba	19	28	25	32	0.76	0.88
British Columbia	24	27	13	14	1.85	1.93
Nova Scotia	17	25	19	21	0.89	1.19

Sources: Byrd, Craig, and Pierre Genereux. 2004. *The Performance of Inter-Provincial and International Exports by Province and Territory Since 1992*. Cat. # 11-621-MIE. Ottawa: Statistics Canada. March; Author's calculations.

posed of the 13 provincial and territorial securities regulators. Ontario has played a leading role in fostering increased regulatory cooperation, particularly in the development of common technical standards, and in initiating movement towards a system of mutual recognition in the review and registration of new securities issues — the passport system. The CSA has also developed proposals for uniform securities legislation to be implemented by all provinces.

A December 2003 report of the federal government's Wise Person's Committee recommended that responsibility for the regulation of capital markets and the securities industry be transferred to federal jurisdiction. This proposal has been coolly received by the several provinces — notably Alberta, British Columbia and Quebec — that are home to a large majority of Canada's small-cap firms and view their powers over securities regulation as a key element in their economic development policies.

The latest stage in this process has been the development of a Memorandum of Understanding among 12 provinces and territories to establish a process for the implementation of the passport system by the end of 2006. Ontario withheld its approval of the passport system in the hope of forcing other provinces to accept a firm timetable for the adoption of uniform securities legislation and the creation of a single national securities regulator.

There is a consensus among federal and provincial regulators, as well as among organizations representing major financial sector interests, institutional investors, and corporate issuers of securities, that the further harmonization of provincial securities regulations and the promotion of best practices in corporate governance deserve political attention, and in some cases, legislative action. However, there is far less consensus on the most effective means of achieving these objectives (Hale and Kukucha forthcoming).

The Tax Collection Agreements, Fiscal Federalism and the Economic Union

Some degree of tax harmonization — the coordination of tax bases, tax administration, and sometimes tax rates — is central to the efficient functioning of economic unions. Tax harmonization can streamline tax administration and contribute to greater economic efficiency, reducing enforcement and compliance costs, as well as dealing with the double taxation of income. It can also help to limit the use of tax shifting and other bother-thy-neighbour techniques that make it harder for governments to pursue coherent, effective policies within their own jurisdictions (Cavlovic and Jackson 2003).

Table 4: *Average Provincial Income Tax Rates (As Percentage of Federal Personal Income Tax Payable)*

	1990	1995	1999	2002	% change 1990-95	% change 1995-99	% change 1999-02
Nfld & Lab	59.1	67.0	69.5	72.5	13.2	3.7	4.3
PEI	55.5	59.3	59.5	64.1	6.8	0.4	7.8
NS	57.3	56.9	56.2	66.2	-0.6	-1.3	17.7
NB	57.2	62.7	60.0	62.8	9.5	-4.2	4.7
Quebec*	88.6	91.6	94.4	na	3.4	3.1	na
Quebec**	61.9	64.4	66.9	na	4.2	3.8	na
Ontario	50.7	58.5	44.7	46.0	15.5	-23.7	2.9
Manitoba	61.7	63.5	62.7	66.3	2.8	-1.2	5.7
Saskatchewan	61.9	68.5	67.0	61.8	10.6	-2.3	-7.8
Alberta	47.3	47.2	46.8	39.0	-0.2	-0.8	-16.7
British Columbia	49.0	54.8	53.4	42.2	11.9	-2.6	-21.0
Territories	42.2	45.0	45.6	39.9	6.8	1.3	-12.5
Canada (incl.Quebec)	53.7	58.8	52.9	na	9.6	-10.1	na
Canada (ex. Quebec)	51.1	57.0	48.7	46.8	11.6	-14.6	-3.8

* Actual

** Adjusted for 16.5% Quebec abatement

Sources: Revenue Canada, Taxation Statistics (1992); Income Statistics (1997); Canada Customs and Revenue Agency (2001, 2004); Income Statistics (1999, 2000); Quebec, Ministere des Finances (2002); Statistiques fiscales des particuliers annee d'imposition (1999); author's calculations.

Canadian federalism has combined relatively high degrees of fiscal autonomy for provincial governments and relatively high levels of tax coordination and harmonization for income taxes, and to lesser degree, for consumption taxes. Canada's tax system is unusual among federations in that sub-national governments have access to virtually all major sources of revenue, except for constitutional limits on indirect taxation, and in that they have considerable latitude in setting their own tax rates. As a result, Canada ranks with Switzerland among the world's most fiscally decentralized federations (Watts 2000). The federal-provincial tax collection agreements (TCAs) enable the federal government to administer the personal income tax (PIT) system for nine provinces (except Quebec) and the corporate income tax system (CIT) for all but three: Ontario, Quebec and Alberta. Effective tax coordination depends on the existence of a common tax base with relatively minor variations. Between 1962 and 2001, participating provinces levied their PITs as a percentage of federal taxes payable by individual taxpayers — although most provinces introduced a number of variations during that period.

Federal-provincial tax competition increased during the 1980s as both levels of government struggled to come to grips with growing deficits, while seeking new ways to finance rising spending on health and other social programs. Sometimes, the integration of federal and provincial tax systems worked to the benefit of provinces, as with Ottawa's partial de-indexation of personal income taxes, which provided a tidy annual fiscal windfall to the provinces. At other times, both levels of government introduced policy changes that cut into one another's tax bases, leading to countervailing policy actions.

Discussions about the possible renegotiation of the tax collection agreements took place in 1990/1991, though talks ran aground for several reasons, including an overloaded political agenda. The imminence of balanced federal budgets in 1997/1998 and the prospect of federal tax reductions created concern at both levels of government about the potential for a return to the tax competition of the 1980s.

Table 5: *Fiscal Federalism and Fiscal Capacity*

	Federal Government			Provincial and Territorial Governments				
	Revenues	Expenditures	Fiscal Balance*	Own Source Revenues	Transfers	Total Revenues	Expenditures	Fiscal Balance*
	index: (adjusted for inflation, population growth)		*2003 $*	*index: adjusted for inflation, population growth*				*2003 $*
1985	100.0	100.0	-61,962.1	100.0	100.0	100.0	100.0	-6,904.9
1990	118.6	106.0	-45,771.8	118.8	97.2	114.0	115.0	-9,510.5
1993	106.9	99.1	-47,689.8	107.5	94.0	104.5	115.0	-24,758.2
1998	123.9	86.5	8,644.3	125.0	68.8	112.5	112.3	-10,156.6
2003	124.9	87.7	4,662.0	130.2	91.3	121.6	118.6	-4,827.0

National Accounts Basis.

* Fiscal balance also reflects capital transfers, allowances and accumulation.

Sources: Canada (2004), Fiscal Reference Tables (Ottawa: Dept. of Finance, October); Statistics Canada.

Regular meetings of federal and provincial finance department officials provided a useful forum to discuss these concerns. Senior officials organized the political support needed to obtain federal and provincial approval of changes to the tax collection agreements between 1998 and 2001. These changes enabled the provinces to rationalize their increasingly complex tax systems and to set their own tax rates and non-refundable credits, based on a common definition of taxable income, along the lines suggested by the Macdonald Commission 15 years before (p. 471).

In several provinces, these changes were preceded by tax reform commissions which introduced significant changes to their respective tax systems and, sometimes, to the mix of taxes levied by individual provinces (Hale 2001). Although provinces have greater freedom to introduce new tax measures than in the past, provisions in the TCAs that pass on resulting increases in administrative and tax collection costs provide a practical incentive to continued federal-provincial tax harmonization.

Arguably, changes to the federal-provincial tax collection agreements have reinforced the economic union by forestalling destructive tax competition between federal and provincial governments and accommodating provinces' very different political and fiscal priorities. These changes have helped to disentangle federal and provincial tax-rate setting processes. Despite fears in some circles about increased tax competition among provinces, sometimes labeled a race to the bottom, most changes to provincial tax rates and mixes appear to have reflected the priorities and ideological commitments of individual governments rather than external policy-induced competition (Hale forthcoming). Table 4 demonstrates the growing divergence — rather than convergence — of effective personal income tax rates between 1990 and 2000 in most neighbouring provinces.

The federal government has also facilitated the coordination of tax administration by reorganizing Revenue Canada as the Canada Customs and Revenue Agency (CCRA), now the Canada Revenue Agency (CRA), accountable to an independent board of directors appointed by federal, provincial and territorial governments.

Fiscal Federalism and Inter-Governmental Transfers

One major area in which the evolution of Canada's economic union has generally not been characterized by cooperation and consensus-building is that of transfer federalism. Reuber and Robson have already noted some of the challenges of managing macro-economic policies during the mid-1980s. A combination of fiscal overextension, growing inter-governmental interdependence and competition, and perverse economic incentives related to the structures of fiscal federalism were steadily eroding the fiscal positions of both senior levels of government.

Under such circumstances, provinces could not set their spending levels independently of revenues and expect the federal government to make up the difference unless they were prepared to concede much greater federal influence over their priorities. Similarly, Ottawa could not expect to shape provincial priorities through the terms of shared-cost programs, and then unilaterally withdraw from its commitments when circumstances changed.

Failures to address these contradictions led to a series of unilateral policy changes during the 1980s and 1990s along with repeated efforts at tax shifting, deficit off-loading and political blame-shifting by both levels of government (Hale 2001). These developments bore little resemblance to the increased inter-governmental policy coordination recommended by the Macdonald Commission.

During the 1990s, these issues finally came to a head in the context of un-coordinated provincial and federal programs of deficit reduction, beginning with most of the smaller provinces. Between 1996 and 1998, reductions in federal transfers to provinces averaged 25 percent, while allowing greater provincial flexibility in the use of remaining transfers.

Since 1998, the gradual restoration of federal transfers to near-1993 levels (Table 5) has been accompanied by somewhat greater degrees of conditionality. Subsequent federal policies have sought to equalize provincial fiscal capacities and lower barriers to mobility among provinces for individual Canadians. Despite the overblown rhetoric of some politicians, there appears to be far less destructive policy competition than in earlier years.

Paradoxically, the medium-term effects of fiscal restructuring may have been to strengthen the economic union by greatly increasing the capacity of the federal government for effective macro-economic management.

Conclusion

During most of the past 20 years, the strengthening of Canada's economic union has arguably been as much an incremental process that has reflected the workings of market forces and pressures arising from regulatory changes in other countries as it has been the result of the deliberate initiatives of Canadian governments.

The most coherent and effective policy changes have been those taken under the authority of individual governments, based on consensual agreements that allowed for significant variations in provincial policies subject to a clear division of responsibilities with Ottawa.

This approach can be seen in the growing federal-provincial cooperation on trade policies, the renegotiation of the federal-provincial tax collection agreements after 1998, and the negotiation of bilateral sectoral agreements in such areas as labour market training or the phasing-out of transportation subsidies.

Comprehensive federal-provincial or inter-provincial agreements, such as those governing the AIT, and attempted reform of securities regulations, are much more difficult to achieve without a formal reassignment of constitutional jurisdictions. The evolution of different institutional structures, policy priorities and political cultures has lent itself to the accommodation of regional interests — as anticipated by the Macdonald Commission — rather than the development of uniform national legislative standards.

To the extent that policy entrepreneurs want to promote common national standards, they will have to mobilize regionally representative coalitions of interests, generally on a sector-by-sector basis, to overcome the constraints of Canada's relatively decentralized federal institutions. An unwillingness to do so, or to identify the shared interests which make such coalition-building across regions a rational exercise in enlightened self-interest, will result in governments' continued frustration.

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Federalism and Canada's Economic Union:
Lessons for the Future

Ken Norrie

The Macdonald Commission was a milestone event when it was announced. As several commentators noted at the time, it was a modern-day version of two earlier high-profile Royal Commissions: the Rowell-Sirois Commission and the Gordon Commission. The research volumes, public consultations and final Report reflect this very broad mandate. Canada has changed fundamentally in the two decades since the release of the Report, in some cases along lines the Commission anticipated and in other ways very differently. Thus, it is entirely appropriate to mark this anniversary by asking what impact the Commission had on this subsequent history, and what lessons for the future we can learn from our conclusions.

My assigned area is Federalism and Canada's Economic Union: At the risk of overlapping with my fellow panelists somewhat, I begin by contrasting the state of the federation in the early 1980s with the situation today. Perhaps not surprisingly, I note profound changes in both circumstances and attitudes. I go on to try to explain this shift and to draw out lessons to be learned. I conclude with some brief comments on what I feel is a key unfinished agenda, one in dire need of quick attention.

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* I follow the lead of many others and thank the C.D. Howe Institute for organizing the conference and for publishing the presentations. I also thank Bill Robson and David Laidler for their very insightful comments and suggestions on an earlier draft of this paper.

The Report's Context

The Macdonald Commission was struck at a time when, in the perception of the academic and political elite at least, Canadian federalism was in a state of crisis. The immediate focus was Quebec. The Parti Québecois had been elected in 1976 with the declared intent of taking that province out of Confederation, and had acted on this platform in 1980 by holding a referendum on sovereignty-association. The referendum failed, but the vote was much closer than many observers expected. There followed the patriation of the Constitution, the enactment of the *Constitution Act*, 1982, and the Canadian Charter of Rights and Freedoms. Quebec came out of these negotiations feeling ganged-up-on and isolated, and as a consequence, refused to sign the *Constitution Act*.

Quebec may have been the immediate focus, but the sense of crisis was exacerbated by a dramatic resurgence of western alienation. The main conflict surrounded federal energy policy following the OPEC-induced oil price increases of 1973/1974 and 1979/1980. The western provinces, Alberta in particular, felt strongly that the federal government had acted unfairly to appropriate energy rents that properly belonged to the provinces. The price controls of the 1970s were controversial enough, but these paled in comparison to the reaction to the National Energy Program of 1980. The high-profile energy wars built on long-simmering discontent about the alleged inherent unfairness of other national economic policies, such as tariffs and transportation regulations, going back to the early days of Confederation.

Crisis is too strong a word, but at the same time there was considerable concern about the operation of the internal economic union. The focus of attention was a growing belief that concerted efforts at what academics were calling province-building were compromising the efficiency of the internal economic union. Provincial governments, in their efforts to promote economic development and to diversify their economies, were imposing barriers to the free flow of goods, services, capital and labour. In addition, the decentralized nature of much economic and social policy suggested to some that Canada's ability to manage its economy effectively was significantly compromised.

Two decades later, the situation is markedly different. With one important exception, namely vertical fiscal balance, federalism issues receive relatively little academic or public attention today, and economic union concerns receive essentially none. Indeed, I would venture to say that federalism and the economic union would not figure prominently in the mandate were a new Macdonald Commission to be struck today.

To illustrate this point, consider the role of Quebec in Confederation. It is unquestionably true that Quebec is much closer to sovereignty now than it was in 1980. In fact, I believe it inevitable that the province will move to some type of associate state status in the next decade or two. But in contrast to the sense of crisis with which previous attempts have been met, I believe that this transition will happen with little or no angst and not even much attention paid outside policy elites in the Ottawa-Montreal-Toronto triangle.

In the West, there has been no new National Energy Policy, even though oil prices are dramatically higher than in 1980. Prominent Albertans are busy back-pedaling from comments on building firewalls around the province. Province-building has largely disappeared as a policy issue, even though provincial governments maintain explicit economic development plans. With the exception of fiscal transfers, discussions of the regional unfairness of federal economic policies are rare.

Assuming that this conclusion is real, and not just simply a view from someone who has been off the policy conference circuit the last few years, the issue is how to explain the difference in the salience of federalism concerns. If there is a compelling explanation, what lessons are to be learned?

Explaining the Shift and Lessons To Be Learned

One explanation for the change in attitude is timing. Crises are often a function of unique personalities and circumstances. The 1970s and early 1980s had a host of strong and charismatic personalities, such as Rene Levesque, Pierre Trudeau and Peter Lougheed. With the possible exception of Alberta's Ralph Klein and perhaps Newfoundland's Danny Williams, today's leaders are a much blander lot.

A second possibility is constitutional fatigue. The two decades following the publication of the Commission's Report were eventful ones. The story is well known (Courchene 2004). Quebec published its conditions for signing the 1982 *Constitution Act*, an initiative that led to the failed Meech Lake Accord. The federal government and eight provinces signed on, but Manitoba and Newfoundland did not; the Accord died in the summer of 1989. This failure led to a number of commissions and enquiries, and eventually to a second agreement. The Charlottetown Accord was put to a national referendum in the summer of 1991 and was soundly defeated. The PQ held a second referendum on sovereignty in 1995 and this time lost by a few thousand votes. One might have thought that the closeness of the vote would raise the salience of the separation issue even further, but this has not happened.

I believe the explanation for the shift in attitudes runs much deeper.[1] To begin, we cannot ignore the progress we have made in reforming the institutions and operation of Canadian federalism and the internal economic union. Senate reform is still a dream of a few Alberta diehards, but other recommendations of the Macdonald Commission have been gradually implemented. One notable example is the Council of the Federation, established largely by the efforts of Quebec Premier Jean Charest. As Courchene (2004) notes, this innovation is the final step in the evolution of what he terms pan-Canadian provincialism. This useful term refers to the willingness of the provincial governments to collaborate to achieve national goals and objectives.

On the economic union front, the most significant development is the Agreement on Internal Trade, introduced in 1994. On the social policy front, the main innovation is the 1999 Social Union Framework Agreement or SUFA. While there is considerable dispute about how effective these institutions actually are, they do represent real institutional change.

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[1] I refer the reader to the excellent chapters in this volume by my fellow panelists, Alan Cairns and Geoffrey Hale, for more detail and analysis.

The provinces were not the only ones revisiting their strategies after the 1995 referendum. Ottawa took a harder line on the Quebec separation front with the passage of the *Clarity Act*. Emboldened by a return to fiscal stability after a dramatic deficit-slashing budget in 1995, and concerned with raising its political visibility, the federal government began to direct expenditures to institutions and individual Canadians. My own sector, post-secondary education (PSE), benefited significantly from this largesse. Two thousand Canada Research Chairs were established, putting operating funds directly into university budgets. The Canada Foundation for Innovation was created, and the budgets of the granting councils were enhanced. The Millennium Scholarship program was established, directing funds to thousands of individual Canadian students. While a newly aggressive federal government was not welcomed in all quarters, Canadians were at least witnessing an end to what had become an impasse of executive federalism.

At least as important in explaining the change in attitudes, however, are two developments which, while not apparently about federalism, in fact had a very profound effect on it: trade liberalization and the popularity of the Charter[2]. Both were the objects of distinct research streams at the Commission, and in retrospect it is clear that we in the federalism and economic union group should have paid more attention to our colleagues down the hall.

These developments together underlie my assertions about the future of Quebec in Canada. Previously, the prospect of separation met with concern on two fronts. The first was the perceived potential for economic disruption, certainly for Quebec, though also for Canada more generally. The assumption was that with regional economies so interwoven, even sovereignty-association would interfere in a significant way with trade and factor flows between Quebec and the other provinces. There was no agreement on what these costs might be, but there is little doubt the issue figured prominently in people's evaluations.

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[2] The improvement in public sector finances and the fall in net foreign liabilities since 1995 are additional factors that explain the reduced anxiety around the prospect of Quebec independence. The question of how to assign responsibility for pubic sector debts featured prominently in the constitutional debates of the 1990s. Indeed, it became commonplace to argue that our inability to resolve this issue, and the consequent severe drubbing we would receive on international financial markets, was a significant barrier to separation. This issue did not figure in the Commission's analysis, mainly because the public sector debt was just beginning to accumulate in the early 1980s.

Free trade has alleviated this concern, however. Canada and the United States signed a free trade agreement in 1988, and a scant five years later this arrangement was extended to include Mexico. Continental free trade has affected trade patterns significantly. International flows of goods and services have grown significantly relative to inter-provincial trade and now nearly all Canadian provinces trade more with their continental partners than they do with each other. The implication, of course, is that potential economic losses from introducing trade barriers between Quebec and the other provinces are now less significant. But just as important, these barriers are also less likely to emerge. In the event of separation, Canada and Quebec, perhaps after some vigorous negotiations, would both be partners in NAFTA and therefore governed by the trade pact's provisions and dispute-resolution mechanisms.[3]

The introduction of the Charter and its popularity among Canadians plays a complementary role. To many Canadians, the prospect of Quebec sovereignty was alarming because it meant giving up on our unique experiment in nation building. The vision of a bilingual, bicultural community was always more a dream than a reality, though it had a powerful hold on the Canadian imagination. The hold was particularly strong among elites in the Toronto-Ottawa-Montreal triangle, but it also reached out to the regions, as the popularity of bilingual schools in Alberta in the 1970s and 1980s attests.

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[3] We would still face significant transitional challenges in the event of a vote for separation, most notably in the areas of banking and finance. See Laidler and Robson (1998).

This sentiment is felt much less today, however. Canada is a very different country now than it was even two decades ago. The Charter has replaced territorial cleavages with rights-based conflicts. Four decades of immigration following the reforms of the 1960s have changed the face of Canada beyond recognition, particularly in the large urban centres. Together, these developments have altered Canadians' sense of identity. The shift is not complete, and likely will never be, but this is the only way I know to explain the reluctance to embrace the Meech Lake Accord and, in particular, the rejection of the Charlottetown Accord.

Quebec may evolve to some type of associate state status in the next decade or so, but I doubt this will take the form of outright separation. There are two reasons for this view. For one thing, despite the relative shift in trade flows, economic ties between Quebec and Canada remain strong. For another, close cultural links remain. Whatever their differences on some issues, it remains true that, on fundamental values and important social issues, Canadians and Quebeckers are more like each other than either is like the Americans.[4]

In the same way, trade liberalization explains the relative lack of discussion and debate on the internal economic union. Province-building strategies are now subject to the discipline of international trade pacts. International market forces and international tribunals are achieving what decades of internal political negotiating could not. Those adding up the economic gains from international trade liberalization should not lose sight of this ancillary benefit. It is also a reminder, if we needed it, that Canada remains a classic small, open economy.

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[4] I readily admit that this is a personal view, unsullied by any rigorous reading and research. Undoubtedly, the reality is much more complex. In support, I cite polls revealing that the great majority of Canadians would have voted for the Democratic candidate in the 2004 presidential election and the apparently greater tolerance in Canada for same-sex marriage, decriminalization of marijuana and gun control. I acknowledge, however, that many Canadians are closer to mainstream U.S. views on these issues, and vice versa.

The Unfinished Agenda

There is some unfinished business, however, and one item in particular looms large on this agenda. Federal-provincial fiscal arrangements have been at the heart of Canadian federalism from the earliest days. Because of this central role, these sometimes arcane policies and formulas are frequently the object of intense scrutiny and debate. That was certainly the case two decades ago when the Macdonald Commission began. There was considerable debate around the structure of the cost-sharing arrangements for health, education and social assistance. The federal government worried about its financial exposure to spending decisions over which it had little or no control. For their part, the provinces felt that the terms of federal transfers did not afford them sufficient flexibility to manage their social programs effectively.

The other discussion was around the equalization program. As a direct outgrowth of the Rowell-Sirois Commission, equalization was intended to allow provinces to provide reasonably equal levels of services with reasonably equal taxation efforts. The principle became enshrined in the *Constitution Act*, 1982, and came to be known as the glue that holds the Canadian federation together. As is often the case, however, the devil was in the details. Equalization entitlements were calculated by comparing tax bases among provinces, using a formula that grew increasingly more complicated over time as new provincial revenue sources were added. The energy price increases of the 1970s and early 1980s, in particular, proved to be formidable challenges to the program, leading to several ad hoc adjustments.

Two decades and much tinkering later, the situation is certainly worse. There is still considerable controversy about federal transfers for social programs, although the issue has been recast in the vocabulary of vertical fiscal imbalance (VFI). Simply put, VFI exists when the expenditure responsibilities of one order of government exceed its revenue capacity, while the opposite is true for the other order of government. The specific claim today is that the federal government is able to generate surpluses because its revenue base grows with the economy more rapidly than its expenditure responsibilities. The converse is said to be true for the provinces. Expenditures on social programs are growing rapidly, while access to revenue is blocked by the federal government's presence in the key taxation fields. This is a constant theme of Quebec commentators, in particular,[5] but it is fair to say that all provinces concur.

This is not the place to enter into a long debate about the theoretical and empirical underpinnings of VFI.[6] To my mind, the real issue comes down to one thing: health care. We have a health care system that has an insatiable appetite for public resources, and no real prospect of containing this appetite anytime soon. Medicare is immensely popular, to the point where it is often identified as a key feature of being Canadian. It is also very expensive and becoming ever more so. Containing these costs is proving impossible because we have a dysfunctional governance system. The federal government is a relatively minor contributor to costs, but through application of the *Canada Health Act* retains considerable authority over the way health care is delivered. The provinces have to deal with the rapidly increasing incremental costs; however, because of federal government controls, they are constrained in their ability to experiment with new models of delivery.

The implication of this deadlock is profound. The provinces are severely constrained in their ability to fund other important policy areas. Let me again take my own sector. The importance of PSE is widely acknowledged. Through education and research activities it is a main contributor to economic growth and social cohesion. It is also widely acknowledged that the sector is poorly funded relative to the U.S. states. But there is little prospect of significant investment in this crucial area until health care spending is brought under control.[7]

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[5] See, for example, Government of Quebec, Commission on Fiscal Imbalance (2002) for a high-profile analysis.

[6] Vertical fiscal imbalance is often presented as an inevitable and permanent feature of Canadian fiscal arrangements. As I have argued on an earlier occasion (Norrie 2002), however, the matter is much more complex, The clearest case of VFI is when one order of government is restricted constitutionally from one or more major tax fields. This was the case, for example, at the time of Confederation when the federal government had exclusive access to the single largest revenue source, customs and excise duties. Today, however, both orders of government have equal constitutional access to all major tax fields. In fact, by the classic definition, the federal government could claim to be the victim, shut out as it is from levying natural resource royalties. Provincial governments may well feel constrained in their ability to balance budgets, but this situation is a complex product of political and economic incentives. See Boadway (2004) for a recent insightful discussion.

Whether the provinces face a vertical fiscal imbalance may be debatable; whether Canada's municipalities do is certain. Municipalities, particularly the largest ones, have great and growing policy responsibilities with little or no authority or independent resources. The implications of not resolving this situation are potentially very serious. To many observers, urban areas are the engines of economic growth in a global, knowledge-based economy. They are also the residual suppliers of social services. But their ability to respond effectively on either count is limited by their revenue base. Infrastructure intended for much smaller populations is crumbling, and there is little scope for providing for new growth. Politicians are at last speaking publicly about the issue, which is encouraging, but any serious attempts at reform will undoubtedly run into significant federal-provincial jurisdictional squabbles.

Sadly, even the venerable equalization program is under attack today. As noted, equalization was deemed central enough to the operation of the federation that it was enshrined in the *Constitution Act*. Unlike other fiscal transfer programs there was a rare acceptance of the principle of equalization, as well as of the inter-provincial redistribution implicit in the program. One reason for this consensus, I believe, was that entitlements were calculated by a transparent, if admittedly complex, formula linking payments to relative tax capacities. As a result, the implicit transfers seemed to be above political expediency.

All this has changed recently. For one thing, the federal government agreed to raise the amount of equalization payments arbitrarily, severing the link to relative provincial fiscal capacities.

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[7] See Laidler (2002) for an early airing of this issue.

Predictably, the 'have' provinces began to question why they should support this arbitrary increase in the amount of the inter-provincial transfer. Shortly after we had a very public spat between the Prime Minister and Newfoundland Premier Williams over off-shore energy revenues, resulting in special arrangements with Newfoundland and Nova Scotia. Other receiving provinces immediately announced their intention to negotiate similar arrangements with respect to non-renewable resource revenues, while the 'have' provinces once again questioned why they should be asked to finance yet another careless election promise. There has long been concern in Alberta about the size of the implicit inter-provincial transfer, but ominously this theme is now frequently voiced in Ontario, as well.

Conclusion

The Macdonald Commission took place at a critical time in Canadian federalism, and it had much to offer in the way of diagnosis and reform. Today, all is much quieter on this front, in part because of the Commission's work, though mainly because of the cumulative effects of trade liberalization, the Charter and decades of immigration. On one key front, however, that of fiscal arrangements, the situation is much worse. Health care costs, municipal finances and equalization would figure large in a new commission's mandate.

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Rapporteur's Commentary

David Laidler

The Macdonald Report marked a major turning point in Canadian economic and social policy and this conference aimed, among other things, at honoring the Commission's achievements 20 years later. Its main focus, however, was on the lessons that we can draw for the future from the Report's prescient conclusions.

In most western countries, post-World War II policy followed the essentially state-directed policy agenda pioneered by the British economists William Henry Beveridge and John Maynard Keynes, as well as the architects of Franklin Delano Roosevelt's New Deal. By the late 1970s, however, that once fast-flowing stream of ideas was rapidly silting up and on its muddy surface inflation and real stagnation were beginning to breed (Macdonald, Chant).[1] In the United States and Britain, particularly, the resulting policy vacuum was being filled by politicians.[2] In Canada, however, a Royal Commission began the process of examining the country's political economy, and its Report (Royal Commission 1985) advocated a redefinition of the state's role in the economy, rather than a wholesale withdrawal. The Commission encouraged the government to maintain its efforts to provide a generous social safety net, and to promote stability and growth, but by creating a stable economic and institutional framework within which a free-market economy would deliver those benefits.

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[1] This rapporteur's commentary draws too heavily on the essays printed earlier in this volume to make comprehensive citations stylistically feasible. They are referred to at particularly relevant points simply by the names of their authors.

[2] "Ronald Thatcher", as Sylvia Ostry reminded the conference.

The Report's Principal Recommendations and Their Impact

The Macdonald Commission is best remembered for its advocacy of a free trade agreement between the U.S. and Canada. Though the 1989 Canada-United States Free Trade Agreement (FTA), enlarged to embrace Mexico in the 1993 North American Free Trade Agreement (NAFTA), differed somewhat from the original recommendation, it involved a major change in the direction of Canadian policy, with economic results that were only partly as predicted (Winham, Trefler). The Commission had foreseen a significant rationalization and expansion of Canadian manufacturing, accompanied by large productivity gains, as well as the possibility of significant transitional labour market problems, and all of these did transpire. However, an overall productivity improvement reflected the closure of inefficient plants under the pressures of competition and the expansion of efficient survivors, as well as significant gains within the latter group, while in the labour market, some of the resulting damage turned out to be permanent rather than transitory (Trefler).

Senate reform was at the centre of the Commission's plans for strengthening the Canadian federation, but it came to nothing (Cairns). Still, piecemeal adjustments in subsequent years enabled federal institutions to cope with the stresses created by the free-trade-related re-orientation of Canada's economic life from an East-West to a series of North-South axes, in spite of the fact that, in the 1990s, the federation's very unity came under threat from Quebec separatism and the reluctance elsewhere in Canada to accommodate the province's distinctiveness. Canada weathered these stresses, too, however, and perhaps the reduced economic inter-dependence of its regions that free trade created actually made the necessary political accommodations easier to manage (Hale, Norrie).

In areas other than trade policy, the Commission's subsequent influence was both less direct and less immediately visible, sometimes because no attempts were made to implement its recommendations, and sometimes because those recommendations were somewhat sketchy. However, the Macdonald Report was much more than a one-idea document, and its positions did inform subsequent policy in a number of areas.

The Commission's substantive proposals for macro-economic policy envisaged little more than stabilizing the public debt-to-gross domestic product (GDP) ratio, and using monetary policy to offset any contraction that this process might cause. It did, though, firmly reject some then-popular ideas and cautiously support others that would soon become fashionable (Chant, O'Neill). Specifically, the Report denied that productivity growth was the enemy of job creation, and ruled out wage-and-price controls as a permanent feature of policy. It also recommended that monetary policy should pursue a medium-term nominal target, albeit nominal GDP growth rather than inflation. It also unequivocally supported a flexible exchange rate as essential to Canada's monetary policy independence (O'Neill, Reuber and Robson).

Three features of the early 1980s help explain the Commission's rather relaxed attitude towards macro-economic policy. For one thing, the reduction of inflation from low-double to mid-single digits at the beginning of that decade had been accompanied by the deepest recession since the 1930s, and Canadians were in no mood to accept another slowdown anytime soon. For another, the net debt-to-GDP ratio for the government sector as a whole was about 35 per cent in 1984, about the same level as in 2003 (OECD figures cited by O'Neill). As well, though the ratio was rising fast in 1984 (in contrast to 2003), there still seemed no imminent danger that it would become uncontrollable because the idea that the slow productivity growth of the preceding decade would still be a drag on tax-revenues even as the economic cycle turned upward was still controversial. At the same time, the Commission looked forward to a significant lift to productivity from the implementation of free trade (Chant, Winham).

In the mid-1980s, then, though macro policy was clearly working badly, there seemed to be time to fix it, and the Commission's very modest concrete proposals were at least directionally appropriate. As it turned out, slow productivity growth was much more than a cyclical phenomenon and Canada's fiscal situation would deteriorate for another decade before the 1995 budget finally put the country's finances on a path consistent with the successful pursuit of the inflation targets that had begun to underpin monetary policy in 1991.

The Macdonald Commission took a bolder approach to the labour market and social policy than to macro-economics (Riddell). Much more striking in 1985 than now was the Commission's acceptance of the idea that unemployment tends to fluctuate around a long-run level — a non-accelerating inflation rate of unemployment (NAIRU) — that is not susceptible to monetary and fiscal policy, but can be affected by micro measures (Chant). Proposals to introduce the experience rating of employers into the unemployment insurance system and to remove regional differences in the program's generosity, among other modifications, were explicitly aimed at reducing the NAIRU, and accurately so in the light of much subsequent research. Political obstacles rather than economic doubts have, however, prevented meaningful reform to this day (Kesselman).

The Commission was also bold in arguing that the simplest cure for poverty is to provide income to those who lack it. This notion underlies Canada's present approach to the specific problem of child poverty, though the Commission's more sweeping proposal for a comprehensive guaranteed minimum income program went nowhere. That the guaranteed-income proposal failed did not reflect another trumping of good economics by politics; rather it was a result of a deepening economic understanding of the limits of such programs and also of the complex nature of poverty itself (Kesselman, Richards). The Commission knew that general income support at any useful level is expensive and that its provision through a pure version of a negative income tax would require rather high marginal tax rates on better-off Canadians. It also understood that any claw-back of benefits at a rate above that embedded in the income tax system itself would imply high effective marginal tax rates for those whose incomes fell in the relevant range. Economists nowadays are even more keenly aware of the inefficiencies in resource allocations associated with high marginal tax rates, and universal programs generally have lost much of their appeal, with even current child support policies sometimes looked at askance (Kesselman).

We have also begun to understand that poverty is often not so much a first cause as an effect of other socio-economic problems that general income support sometimes does little to ease, and that marginal dollars might be more effective in reducing poverty when directed to specific programs. This seems to be particularly the case with child poverty because the social problems associated with it often affect the educational achievements of children, their subsequent labour market experience, and the eventual social and economic well-being of their own children (Kesselman, Richards).

The Commission advocated special transitional relief for workers displaced by the introduction of free trade with the U.S. This proposal, too, never got off the ground and, in fact, when considered in the light of actual post-FTA experience, the Commission may have been addressing the wrong problem in any case. Many low productivity workers, whose poor education made it hard for them to move into other jobs, suffered long-term rather than temporary losses (Trefler). In an economy as open to foreign competition as Canada's has become, such difficulties are permanent features of the labour market and their remedy seems to lie in ensuring that higher minimum levels of education are attained than in the past. Viewed in this light, the currently high drop-out rates of high school students, particularly those of young men, do not augur well for the future.

Looking Ahead

Twenty years after the Macdonald Commission reported, Canada still has much policy work to do.

Poverty is a case in point. Since 1985, Canada has lessened the prevalence of welfare traps — those quirks in the profile of effective marginal tax rates that provide incentives for people to stay out of the labour force altogether. However, they have often been replaced by success traps — which remove incentives for low-productivity workers to take the risks implicit in acquiring extra education and training in order to raise their incomes from employment (Kesselman). Not only that, in relying as heavily as we now do on income support to families to fight poverty among children, we may be missing opportunities to improve their educational attainments and their long-run income prospects, as well as those of future generations (Richards).

In this context, social and labour market policies come into contact with a central piece of unfinished macro-economic business, the pursuit of higher productivity growth. Many commentators have stressed the importance of human capital in this area, though the focus has been almost exclusively on post-secondary education and the knowledge economy. Too often they have overlooked the importance of improvements in primary and secondary education that would not only contribute to the growth of Canada's stock of human capital, but also contribute to the amelioration of poverty. The connections among these policy goals are underappreciated.

As well, what is now called Employment Insurance (EI) still needs reform. Many might argue that this cause is almost lost and not worth the expenditure of scarce political energy. Perhaps, but public awareness and disquiet about the extent to which, under current arrangements, the revenue raised from employment insurance payments exceeds the payment of benefits might just generate enough political energy to support action and to create an occasion to re-base the current EI scheme on insurance principles. It is, therefore, worth keeping our understanding of these issues alive and up-to-date and being ready to exploit the opportunity should it arise. This is not the only area where such an attitude might pay dividends. Canada's current two-percent inflation target is hard to defend as an ideal long-run anchor for monetary policy; it endures, in part, because many think the efforts involved in moving closer to price stability outweigh the benefits of doing so (Reuber and Robson). Here too, however, an unexpected opportunity to make an improvement could conceivably arise.[3]

More generally, reform of Canada's overall fiscal system has considerable potential to improve the economy's performance (Reuber and Robson). An increase in the tax system's efficiency, especially in the corporate area, would help productivity, an important consideration now that the gains from free trade have largely been captured.[4] Furthermore, the creation of a well-designed medium-term federal budgetary framework might complement inflation targeting in creating the reliable macro-economic stability that is so conducive to good business decisions.

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[3] As former Bank of Canada Governor John Crow reminded the conference.

Currently, the unpredictability of federal outlays under shared-cost programs continuously threatens medium-term fiscal stability, while also exacerbating the apparently perpetual political tensions to which Canada's political union is subject (Reuber and Robson, Hale, Norrie). Senate reform, the Macdonald Commission's principal remedy for relieving such political stresses, proved elusive and, though a good deal of piecemeal progress has been made since the 1980s in maintaining and even improving Canada's economic union, successive federal governments have not identified a policy goal that can form the centrepiece of a nation-building political agenda. Recently, solving the problem of health care for a generation has been assigned this role, though there should be concern about this casting (Norrie).

Political support for the current system is certainly strong and national in scope, but health care remains under provincial jurisdiction and is funded on a shared-cost basis. The federal government's efforts to use its spending power to influence provincial policies in this area, with a view to setting national standards, seem bound to create fiscal uncertainty and to exacerbate federal-provincial tensions, as well. Perhaps it would be better to concentrate nation-building efforts in areas where federal jurisdiction is clear and not subject to provincial challenges: foreign affairs in general, say, and defense and trade policy in particular.

Policy towards the U.S. is now very much on Canada's agenda. Perhaps the emergence of such economic giants as India, China and Brazil is indeed opening up new opportunities for trade diversification (Winham). In fact, though, the Canadian economy is now more dependent on trade with the U.S., and in some areas much more deeply integrated into the U.S. economy, than it was 20 years ago, and any discussion of trade policy must have this reality as its starting point (Winham, Hart).

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[4] In this context, though, it is worth noting explicitly that such measures as EI reform, designed to improve the employment prospects of low productivity workers would actually hold down measured productivity, but should not be avoided for that reason.

Indeed, Canada-U.S. trade poses many challenges. Disputes with the U.S. persist, notably over softwood lumber, while cross-border road and bridge links, particularly those that are so vital to the smooth functioning of the automotive industry, are already badly stretched by the sheer weight of traffic and are in constant danger of becoming chronically congested as a result of post-September 11, 2001, security measures. At the same time, the conventional gains from free trade within North America now seem to have been largely exhausted (Winham, Hart). In Canada, they are, in fact, being eroded as the U.S. expands a network of bilateral free-trade agreements that exposes Canadian exports to increased competition from third parties, while simultaneously enhancing the relative attractiveness of the U.S. as a location for North American production.[5]

The status quo in Canada's trade relations with the U.S. is, at best, unstable and perhaps unsustainable, particularly at a time when strong differences of opinion about the invasion and occupation of Iraq and continental missile defense have strained political relations. These matters require attention, and the phrase Tinker or Transform neatly summarizes Canada's dilemma (Hart). Should the aim be piecemeal improvements to the status quo where possible, and its ad hoc management where they are not, or should the big idea of much deeper North American economic integration be pursued? There can be little doubt about the purely economic attractions of the latter option. The gains to be had from regulatory integration between the two countries, from the creation of a customs union and a common security perimeter that would permit the opening up of the U.S.-Canada border to the free movement of goods, services and people, would surely generate noticeable material benefits and because of the differences in size between the two countries it is hard to see how the advances would not be particularly significant for Canada (Hart).

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[5] As Ronald Wonnacott ruefully remarked to the conference, for Canada, at least one fate would be worse than to assume the status of a spoke in an emerging U.S.-centred hub and spoke trading system: namely, to be excluded from the system altogether.

There are, however, serious political issues at stake. Perhaps many Canadians might accept common regulatory standards for automobile safety, or perhaps for food and drug safety, even if, as would be likely, the bigger country ended up having the predominant say in both their configuration and enforcement. But, suppose a customs union agreement were to involve something as apparently simple as Canada adopting U.S. policy towards trade in sugar? What would that do to the country's ability to act independently in the Caribbean and elsewhere in other matters? And what might a common security perimeter and a more open border than now exists imply for Canadians' ability to exercise their own judgment in the areas of immigration and refugee policy?

A badly conceived and executed version of the big idea could create a degree of dependence in matters of trade and investment large enough to put significant limits on the effective powers of Canadian governments to formulate independent policies in areas where the electorate's ability to enforce accountability upon them is currently taken for granted. This very consideration led the Macdonald Commission to recommend that Canada seek a free trade agreement rather than any deeper relationship with the U.S., and it remains critically relevant to our choices today.[6] It is highly unlikely that deeper economic integration of Canada into the U.S. would lead to it becoming a 51st state.[7] Should that happen, though, former Canadians would at least be able to participate fully and equally in U.S. democratic processes, as they would not were Canada to stumble into the status of a dependent territory, subservient in foreign policy, but with some scope for self-government in matters that are judged by the U.S. authorities to be of purely domestic Canadian interest.[8]

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[6] Specifically, the Commission noted that Canada had in the past exercised policy independence towards China and Cuba (Volume I, p. 306.) and, prophetically, expressed concern that even the degree of economic integration implicit in a free-trade agreement could lead to pressures on the Canadian government to support future U.S. military interventions in Latin America and elsewhere that might prove politically divisive at home (p. 361).

[7] As Winham ironically suggested during the course of a discussion with Hart about how far it was desirable to push North American integration.

This is not the place to debate specific versions of the big idea for Canada's place in North America. These need dispassionate analysis to reveal their advantages and potential flaws, in which it is important to avoid at least two pitfalls. First, we should recognize the claim that much deeper economic integration in North America is already inevitable, with only some details remaining to be discussed, as a rhetorical device intended to pre-empt careful criticism of this option. Second, we should recall that Allan Gotlieb's (2004) suggestion that Canada reject romanticism in favour of realism in foreign policy was not intended as a call to put the pursuit of material gain above adherence to political ideals. Rather it was a reminder that, in general, to ignore political and economic constraints in the pursuit of ideals can be dangerous and that such a pursuit can sometimes come at a significant material cost that might not — or might, depending on specifics — be worth incurring, but should always be taken explicitly into account when formulating policy.

Conclusion

Though policy in any democracy necessarily proceeds in piecemeal fashion, concentrated in particular areas, rather than according to a single overarching plan, it is sometimes worthwhile to step back from the details and look at how they interact. And it is also valuable to bring the best available academic analysis to bear on these matters. The Macdonald Report showed the value of doing these things and so, we hope, in its smaller way, will the proceedings of this conference.

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[8] To judge by the alacrity with which representatives of the U.S. government, apparently with support from Canadian opponents of the measure, noted the likely side-effects of the decriminalization of the possession of small amounts of marijuana on the smooth flow of traffic across the border, the range of such matters might prove to be remarkably restricted.

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Progress and Challenges 20 Years after the Macdonald Commission

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David E.W. Laidler and William B.P. Robson, Editors

This book contains the proceedings of a conference celebrating the 20th anniversary of the Macdonald Royal Commission Report. Its publication in September 1985 marked a turning point in Canadian thinking about economic and social policy. By the early 1980s, double-digit inflation and severe recession had undermined confidence in the activist policy agenda that had served the country so well after World War II. The federal government asked the Macdonald Commission for a fundamental re-examination of the country's economic and political future, and it provided just that.

The Report's over-riding theme was that governments should step away from policy activism and provide instead a background of economic stability against which members of the private sector could respond to new challenges in their own ways. The most famous of the Commission's specific proposals — that Canada should seek a free trade agreement with the United States — was soon taken up by the federal government; however the Report's many other recommendations influenced a broad swath of policies in subsequent years.

The conference dealt not only with how the Report's ideas about macroeconomics, labour markets and social policy, international trade, and the economic union and federalism, worked out in practice, it also ranged over new notions about how to cope with the current problems Canada faces in these areas. The resulting volume honours the Macdonald Commission, not just by commemorating its work, but also by looking ahead and trying to emulate its spirit.

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